dence to show that such coverage ratios must be maintained at levels comparable to those of 1954 and prior years, nor is there evidence of comparability with other companies and industries to show that the quality of Tennessee's senior securities will suffer in the market place if Tennessee is not given the 7 percent rate of return which it seeks.

There is likewise no substantial evidence to support Tennessee's contention that it needs a 14 to 15 percent return on common equity because certain electric utilities have had an average return of almost 11 percent over a period of years. We are not convinced that the selection of electric utilities made by Tennessee presents a proper basis for comparison, or that the differing risks inherent in the two industries can be measured as Tennessee here proposes. It is significant to note that according to Tennessee's own study, the three largest electric utilities for which data is shown—namely, Consolidated Edison Company of New York, Pacific Gas and Electric Company and Public Service Electric and Gas Company—had earnings on common equity for 1958 of 8.1, 9.7 and 8.6 percent, respectively.

Upon consideration of the earnings-price ratio data and all the factors discussed above, and giving consideration to the corporate costs of equity financing, we conclude that an allowance on common equity of between 10 and 10.5 percent is fully adequate for Tennessee, and is sufficient to enable Tennessee to attract new equity capital and preserve its financial integrity. As indicated in the table set forth above, an overall rate of return of 6⅛ percent will provide Tennessee an allowance of of 10.12 percent on its common equity, and we shall therefore fix the fair, just and reasonable rate of return to Tennessee for the purpose of this interim order at 6⅛ percent.

The overall rate of return so determined is applicable to all of Tennessee's properties, including well-mouth pro-

duction properties. Tennessee has not urged, nor does the record at this point in the proceeding show, that Tennessee is entitled to any different rate or return on its production properties. This question, however, is bound up with the question of the treatment of tax benefits for statutory depletion and intangible well drilling costs, which we are reserving for disposition in the next phase of the proceeding. Thus final determination of the proper rate of return on production properties cannot be made at this time, but will be made upon conclusion of the next phase of the proceeding.

IMMEDIATE REFUNDS

The propriety and legality of ordering immediate refunds of amounts which Tennessee has collected subject to refund since April 5, 1960, has been settled by our recent order in the *Southern Natural* case, *supra*. The purpose of the interim order procedure is to alleviate, to the extent possible, the financial burden of increased rates being borne by Tennessee's

wholesale gas customers. The record shows that if the rate of return herein determined were 6 percent, the effect of such rate of return and associated income taxes would result in savings to these customers during the interim period in the amount of $13,037,649 a year. Although the savings will be somewhat less on the basis of the 6⅛ percent rate of return herein determined, the amount of the savings are of such magnitude that the public interest requires disallowance of Tennessee's proposed rates and a filing of substitute rates based on the 6⅛ percent rate of return, such substitute lower rates to be effective as of April 5, 1960.

Immediate refunds of the increased rates collected by Tennessee since April 5, 1960, to the extent that such rates

exceed the substitute lower rates based on the $6\frac{1}{8}$ percent rate of return, will put Tennessee and its customers in the same position that they would be in had Tennessee initially filed its increased rates on the basis of the $6\frac{1}{8}$ percent rate of return which we here find to be the proper rate of return. Tennessee should not be permitted to retain amounts which it has collected on the basis of an unlawful rate of return, and we shall therefore order immediate refunds of these amounts.

Tennessee argues here, as did Southern in the *Southern Natural* case, that the interim order procedure is unlawful and inequitable unless the Commission makes final disposition of the complex issues of cost allocation and rate design at the same time it determines the proper rate of return, since Tennessee may not be able to recover its cost of service should the Commission decide these issues in such a way that Tennessee would have to make refunds in certain zones where its rates are found to be too high but could recover revenues retroactively in those zones where it has charged less than the finally determined cost of service. This argument was fully answered by us in the *Southern Natural* order where we concluded (mimeo. page 3):

> "Should Southern suffer legal injury by reason of the Commission's final order in the second phase of this proceeding, it may seek judicial review. It cannot, however, be heard to complain of an order which fixes a proper rate of return and looks only to the establishment of interim rate levels based on such proper return and which in all other respects are based on the methods and procedures employed by Southern in making its rate filing, including its own allocation and rate design methods.

Certain of the intervening customer companies have expressed the fear that their right to receive funds of all

amounts collected from them by Tennessee, in excess of what is finally determined upon the conclusion of the next phase of the proceeding to be just and reasonable, will be prejudiced by an order at this time directing interim refunds upon the allocation and rate design methods proposed by Tennessee. We cannot agree that these customers will be so prejudiced by this interim order. As noted above, this order serves to place such customers in the same position

as if Tennessee had initially filed its proposed increased rates utilizing the rate of return which we herein find to be proper. Tennessee's customers will be afforded all the protection provided by the terms of the Natural Gas Act.

The Commission finds:

(1) The fair, just and reasonable rate of return to be allowed Tennessee in this proceeding is $6\frac{1}{8}$ percent; subject, however, to final disposition in the next phase of this proceeding of the related issues as to accumulated deferred taxes and tax benefits for statutory depletion and intangible drilling expenses, and final determination of the rate of return to be allowed Tennessee with respect to its wellmouth production properties; and subject to such further consideration as may be required in light of additional evidence which shall be presented in the next phase of the proceeding to show Tennessee's capitalization insofar as it applies only to Tennessee's gas pipeline business.

(2) The proposed increased rates filed in this proceeding by Tennessee, and presently being collected by Tennessee subject to refund under the order of the Commission issued April 29, 1960, whereby the proposed increased rates became effective as of April 5, 1960, are excessive and should be disallowed.

(3) Tennessee should be permitted to file herein substitute lower rates satisfactory to the Commission, based on the $6\frac{1}{8}$ percent rate of return herein found to be proper for the purpose of this interim order, such substitute lower rates to become effective as of April 5, 1960, upon acceptance by the Commission, subject to refund in accordance with the Commission's order of April 29, 1960, and the undertaking heretofore filed by Tennessee in accordance with the terms of that order.

(4) Tennessee should be required to make prompt refunds with interest at 7 percent, in accordance with the Commission's order of April 29, 1960, and the undertaking heretofore filed by Tennessee, of all amounts collected by it from its jurisdictional customers subject to refund under its proposed increased rates; provided, however, that if Tennessee files substitute lower rates as herein provided, the amount of such refunds should be the excess of the amounts so collected over what it would have collected on the basis of the substitute lower rates so filed and found to be satisfactory by the Commission. A plan for making such refunds should be submitted for approval of the Commission.

The Commission orders:

(A) The proposed increased rates filed in this proceeding by Tennessee are hereby disallowed.

(B) Tennessee may, within 15 days of the date of this order, file in lieu thereof appropriate substitute tariff sheets to its FPC Gas Tariffs containing lower rates satisfactory to the Commission, based on the $6\frac{1}{8}$ percent rate of return herein found to be proper for the purpose of this interim order. Tennessee shall accompany its substitute filing with supporting cost of service and allocation data, to be

computed and presented in the same form and manner as contained in its exhibits heretofore offered by it in this proceeding, revised only to reflect a 6⅛ percent rate of return and Federal income taxes associated therewith. Tennessee shall further furnish with its filing a statement setting forth the method of computation of such substitute rates and showing the derivation thereof. Tennessee shall also accompany its substitute tariff sheets and supporting data with a certificate showing service of copies thereof on all purchasers under the rate schedules involved, interveners in this proceeding, and interested state commissions. Comments by such parties shall be submitted to the Commission within ten days after service by Tennessee as required herein.

(C) Upon acceptance of such filing of substitute rates as satisfactory to the Commission, the rates, charges and classifications set forth in Tennessee's substitute tariff sheets shall become effective as of April 5, 1960, subject to refund, in accordance with the Commission's order of April 29, 1960, and the undertaking heretofore filed by Tennessee in compliance with the terms of that order, and subject to further orders of the Commission in this proceeding.

(D) Tennessee shall, within 15 days of the date of this order, file with the Commission its plan for promptly refunding to its jurisdictional customers the amounts which by finding paragraph (4) the Commission has found should be refunded by this order. Tennessee shall accompany its plan for refunds with a statement setting forth the computation of the refunds and interest, and the derivation thereof. Tennessee shall also accompany its plan for refunds and supporting statement with a certificate showing service of copies thereof on all purchasers under the rate schedules involved, interveners in this proceeding, and interested state commissions. Comments by such parties shall be submitted to the Commission within ten days after

service by Tennessee as required herein. Upon approval by the Commission of said plan of refunding Tennessee shall make the refunds as so approved within 30 days thereafter, and shall report to the Commission within said 30 days the amounts so refunded to each jurisdictional customer.

(F) Tennessee shall, in the next phase of this proceeding, present additional evidence to show its capitalization insofar as it applies only to its gas pipeline business, as more fully discussed in the body of this order.

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(F) The issues as to accumulated deferred taxes and tax benefits for statutory depletion and intangible well drilling expenses, and final determination of the rate of return on Tennessee's well-mouth production properties, shall be reserved for the next phase of this proceeding, together with all other issues as yet undisposed of, and further consideration shall be given at that time to the additional evidence with respect to rate of return presented by Tennessee in accordance with paragraph (E) above.

(G) This order is without prejudice to further hearings in this proceeding on the reserved issues not herein decided and to such further order or orders as the Commission may issue in the disposition of the reserved issues and in final disposition of this proceeding.

By the Commission. Chairman Kuykendall dissents and states he would allow a rate of return of 6¼%.

J. H. Gutride
Joseph H. Gutride
Secretary.

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UNITED STATES OF AMERICA

BEFORE THE FEDERAL POWER COMMISSION

Docket No. G-19983

In the Matter of

TENNESSEE GAS TRANSMISSION COMPANY

Application of Tennessee Gas Transmission Company For Rehearing of Order Issued August 9, 1960

Tennessee Gas Transmission Company (Tennessee), being aggrieved by the Commission's "Order Determining Rate of Return Disallowing Proposed Increased Rates and Directing Payment of Refunds and Permitting Substitution of Lower Interim Rates," issued herein on August 9, 1960, hereby applies, pursuant to Section 19 of the Natural Gas Act and Section 1.34 of the Commission's Rules of Practice and Procedure, for rehearing of that order. The grounds upon which this application is based are set forth below.

Preliminary Statement

This is not a perfunctory application for rehearing filed solely to perfect an appeal to the Court. It is, rather, an earnest appeal to the conscience and judgment of this Commission to prevent grave injustice and irreparable harm to Tennessee, its investors and the public which it serves. The Commission's order is so shocking, and its impact upon Tennessee's financial integrity and ability to continue to render adequate service to the public so adverse, as to overwhelmingly require the granting of this application for rehearing.

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Since its birth in 1944, Tennessee has faithfully rendered complete and adequate service to its customers. It has

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expanded faster than any other natural-gas company in the country in an effort to meet the growing needs of the public for natural gas. Its stockholders have invested hundreds of millions of dollars in good faith in reliance upon the enlightened past policy of the Commission of allowing a fair rate of return on the common equity of Tennessee. The Commission's order constitutes an abrupt and cruel reversal of such past established policy which is so drastic in its consequences as to lead to the inevitable conclusion that the order is arbitrary and lacks a rational basis.

The violent change in the Commission's past policy and the destructive force of the Commission's order can be readily demonstrated. In Tennessee's previous rate case (Docket G-5259) the Commission expressly found that rates fixed on the basis of a 6 percent rate of return were "*just and reasonable.*" (18 F.P.C. 428, 437). That finding was based on the financial facts shown in that record for the year 1955 (18 F.P.C. at p. 441).[1] Since that time, yields on "A" bonds have increased by 54 percent; yields on U.S. Government bonds have increased 43 percent; and the average cost of Tennessee's total long-term debt has increased 24 percent. Yet, the Commission's present order increases Tennessee's over-all rate of return from 6 percent to $6\frac{1}{8}$ percent, an increase of

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only 2.1 percent. It is obvious at once that what the Commission has done here is to require Tennessee's stockholders to absorb virtually the entire 24 percent increase in the cost of long-term debt which Tennessee has incurred since 1955. The irony of this is that the increased cost of the long-term debt was the direct result of Tennessee's expansion of its system capacity to meet the growing gas require-

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[1] Some 36 pages of detailed statistical data on rate of return were presented in that case through a Staff expert witness, in addition to the evidence on rate of return presented by Tennessee.

ments of the public. If Tennessee had failed to expand, it would not have incurred this increased cost of debt and it would not have been necessary to seek the higher rate of return applied for in this case. Under those circumstances, Tennessee's stockholders would have continued to enjoy the return which the Commission allowed to them in the previous rate case without seeking any increase in the rate of return. In short, the "reward" which the Commission's present order gives Tennessee's stockholders for expanding its system capacity to meet the increased gas requirements of its customers is a *reduction* in the return on their book equity from the rate of 13.71 percent previously allowed in Docket G-5259 [2] to only 10.12 percent in this case. This is a *reduction* of 26 percent. Does this Commission really believe that the stockholders of Tennessee will be encouraged to expand capacity in the future after having thus been "rewarded" with a 26 percent cut in their earnings for having expanded Tennessee's capacity during the past four years?

It is evident that the Commission's interim order places in serious jeopardy, if it does not completely prevent, any further significant expansion of Tennessee's jurisdictional pipeline business. Indeed, so

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serious is the threat of the Commission's order to Tennessee's plans for future expansion that the company has found it necessary to reconsider the feasibility of going forward with the expansion program applied for in Docket CP60-94, and is requesting the Commission to hold in abeyance all action in connection with its application in that docket pending re-examination and further study of the feasibility of that project in the light of the Commission's interim order.

[2] 18 F.P.C. at p. 441.

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Will the Commission's return of $6\frac{1}{8}$ percent encourage expansion? Certainly not. On the contrary, it discourages expansion for the simple reason that under the Commission's new and destructive policy of requiring the stockholders to absorb the higher cost of debt incurred in financing new facilities, they stand to lose more ground with each succeeding step of expansion. A simple illustration will serve to demonstrate the erosion that takes place in the equity position under the Commission's order. Assume that each \$100 of additional capital raised for financing expansion consists of \$57 of bonds, \$14 of preferred stock and \$29 of common stock, which is the approximate capitalization ratio shown on page 3 of the order. With the present day cost of bonds and preferred stock hovering around $5\frac{1}{2}$ percent, the Commission's over-all rate of return of $6\frac{1}{8}$ percent will yield a return for such new common equity increment of only 7.6 percent. How, we ask, can new equity capital be attracted to this enterprise for such a paltry reward?

Tennessee was born under F.P.C. regulation. It has expanded and financed under the watchful eye of this Commission. Its rates have been under constant surveillance by the Commission. Investors have poured

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many hundreds of millions of dollars into this enterprise in good faith and reliance upon the past decisions of this Commission on Tennessee's certificate and rate matters. The Commission has consistently, since Tennessee's birth in 1944, allowed Tennessee to charge rates which enabled it to earn a rate of return in the neighborhood of 14 percent on its common book equity. The hundreds of thousands of persons and institutions who invested their money in the common stock of Tennessee over the years paid prices for that stock which reflected such earnings. In so doing they

relied upon the previous rate orders of this Commission which found that Tennessee's rates fixed on this basis were "just and reasonable." Stated another way, they relied upon a continuation of the past policy of the Commission with regard to the determination of the fair and reasonable return on common book equity. The Commission cannot now brush aside the responsibility for the consequences of its action in arbitrarily cutting the return on Tennessee's equity by 26 percent with the mere general observation that "There is no sound basis for Tennessee's claim that it is entitled to the same return on book equity which it has historically enjoyed."[3] (p. 6 of order). It cannot be gainsaid that it was the Commission's own action in maintaining a consistent policy in numerous Tennessee rate cases over the past 16 years which formed the basis in the minds of investors for the belief that such policy would be continued in the future.

The return here allowed on Tennessee's common book equity is far and away the lowest ever allowed to Tennessee. Indeed, it is the lowest ever allowed by the Commission on an equity of such thickness to any

natural-gas company in the past decade. The Commission has recently indicated that it is not oblivious of the fact that the cost of money has risen in recent times. It recently required natural-gas companies to increase the rate of interest on refunds to customers from 6 percent to 7 percent. It very recently increased the rate of return to two other natural-gas companies, namely Southern Natural Gas Company (Docket G-20509) and Manufacturers Light and Heat Company, to 6½ percent (23 F.P.C. 446).

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[3] As shown later herein, Tennessee is not claiming the same return on its common book equity which it previously enjoyed, but rather is claiming an equivalent return (12.5%) on its present thicker book equity.

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In so doing, the Commission allowed those companies to earn higher rates of return than Tennessee on their common book equities in the face of the fact that such equities were thicker and hence less risky than that of Tennessee. Such rank discrimination against Tennessee defies our understanding.

It has been the Commission's consistent and sound policy since the passage of the Natural Gas Act to allow a fairly uniform over-all rate of return to the natural-gas industry. The result of this sound policy was to consistently allow higher returns on thinner and less secure common equities than on thicker and more secure common equities. And, as the Commission knows, the industry has expanded and serve the public well under such policy. As we read the Commission's recent orders, that policy has now been abruptly reversed. The Commission now allows a uniform rate of return (around 10 percent) on common book equity, irrespective of the thickness or thinness of such equity. This new policy has produced the absurd and discriminatory result of allowing a higher over-all rate of return to those companies having thicker and, therefore, less risky equities than to those having thinner and, therefore, more risky equities. This reversal of policy simply does not make economic and financial sense. If pursued it will2 convert the natural-gas pipeline business from a strong and healthy industry into a sick industry.

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Additionally, as more fully shown below, the interim decision procedure adopted by the Commission is clearly unlawful. The Natural Gas Act requires the Commission to first find that the filed rates are "unjust, unreasonable, unduly discriminatory, or preferential" before it can prescribe different rates. It cannot now enter such a finding because it has not yet decided the allocation issue which

holds the key to the question of whether the filed rates are too high or too low in any of the six zones. The Act also requires the Commission to determine and fix the "just and reasonable" rate to be charged "after full hearing." The Commission has not yet held "full hearings" on all issues affecting the reasonableness of the filed rates, and it has failed and refused to decide the allocation issue, without which it cannot determine what rates shall be prescribed for the various zones. Instead of fixing rates as required by the Act, the Commission has unlawfully attempted to delegate, under pain of economic sanctions to Tennessee the responsibility of fixing the rates to be charged under the interim order and, in so doing, to assume the risk of not being able to recover its cost of service depending on the outcome of the Commission's later decision on the allocation issue. The glaring unfairness of such interim order procedure is even more apparent when it is recognized that the allocation issue has been fully tried during the past three years, has been fully briefed, and has been ripe for decision for several months. There is no excuse for the Commission to place Tennessee in jeopardy of not recovering its cost of service, including even the meagre 6⅛ percent rate of return allowance, simply because the Commission arbitrarily refuses to decide an issue which is now ripe for decision.

I

Rate of Return

The Commission, in the order here involved, concluded that a rate of return of 6⅛ percent is "the fair, just and reasonable rate of return to be allowed Tennessee for the purpose of this interim order." We respectfully submit that such conclusion is erroneous in fact and in law, is not supported by substantial evidence of record, and is not

supported by adequate findings. Such rate of return, if permitted to stand, is confiscatory, deprives Tennessee of property without due process of law, and would clearly constitute discriminatory and arbitrary and capricious action against Tennessee.

Returns Recently Allowed Other Pipeline Companies

The $6\frac{1}{8}$ percent return allowed Tennessee by the Commission results in a return on its common book equity of only 10.12 percent. Such a return on the common equity[4] ratio of 29.5 percent used by the Commission (see p. 3 of order) is patently unfair, unjust and unreasonable. Such a return, if permitted to stand, will place Tennessee at a decided disadvantage in competing for capital with other regulated industries, including other pipeline companies.

The $6\frac{1}{8}$ percent rate of return allowed Tennessee is to be contrasted with the rates of return allowed in the two most recent rate of return cases decided by the Commission, namely, the *Manufacturers Light*

and Heat Company case (23 F.P.C. 446) issued February 25, 1960, and the *Southern Natural Gas Company* case (Docket G-20509) issued July 8, 1960. In each of these cases, the Commission allowed an over-all rate of return of $6\frac{1}{2}$ percent. In each of these cases, the returns allowed on the respective common equities were *higher* than the return allowed on Tennessee's common equity. In each of these cases, the common equity was *thicker* than the common equity of Tennessee, and, as the Commission has long recognized, a thinner common equity demands a higher rate of return because of the greater risk involved. In

[4] Throughout this document, the term "common equity" means "common stock book equity."

each of these cases, the *actual* unadjusted imbedded cost of debt was *less* than Tennessee's cost of debt.

Clearly, then, the 6⅛ percent return which the Commission would allow Tennessee is not commensurate with the returns on investments the Commission itself has just recently allowed other pipeline companies. Clearly, the 6⅛ percent return allowed Tennessee arbitrarily discriminates against Tennessee.

In the *Manufacturers* case, the Commission allowed a return on common equity of 10.35 percent on an equity ratio of 40.3 percent. If the same rationale were to be applied to Tennessee, it would, because of Tennessee's higher imbedded debt cost, result in an over-all rate of return to Tennessee of 6.77 percent, assuming Tennessee had the *identical* capital structure as that used by the Commission in the *Manufacturers* case. The computation is as follows:

Debt	59.7%	at	4.35%	=	2.60%
Common Equity	40.3%	at	10.35%	=	4.17%
Total					6.77%

In the *Southern* case, the Commission allowed a return on common equity of 10.18 percent on a common equity ratio of approximately 36 percent. Assuming the same capital structure for Tennessee as that used by the Commission in the *Southern* case, even the meagre return allowed in the *Southern* case would result in an over-all rate of return of almost 6½ percent for Tennessee. The computation is as follows:

Debt	64.2%	at	4.35%	=	2.79%
Common Equity	35.8%	at	10.18%	=	3.64%
Total					6.43%

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As pointed out above, Manufacturers and Southern were not only allowed higher over-all rates of return and higher returns on their common equity than was Tennessee, but their equity ratios were thicker than that of Tennessee. As the Commission has long recognized, and as shown by the record herein, a lower equity ratio, because of the greater degree of risk involved, demands a higher rate of return (Tr. 167, 171-2). Indeed, as shown by Exhibit 13, pp. 22 and 23, it has been the consistent practice of the Commission to allow higher percentage allowances on thinner equities and lower allowances on thicker equities (Tr. 141).

The evidence shows that on the basis of returns to equity previously allowed by the Commission, a difference in return of about 1.5

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percentage points is required for the 10-point difference in equity ratio between 30 percent and 40 percent (Exh. 13, p. 23). Accordingly, assuming that the 10.35 percent return allowed on Manufacturers' equity ratio of 40 percent is reasonable, the return on Tennessee's common equity would have to be approximately 11.9 per cent to give effect to the lower equity ratio (29.5 percent) of Tennessee. As shown by page 4 of the Commission's order here involved, a return on Tennessee's common equity of 11.9 per-

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[5] This is obviously necessary. For instance, if the Columbia System (the parent of Manufacturers) capitalization consisted solely of common stock equity capital, the Commission would not have allowed thereon the 10.35 percent which it allowed on the common stock equity capital amounting to 40 percent of total capital. A uniform percentage allowance on common stock equity capital, regardless of the proportion thereof in the total capitalization, would be completely at odds with regulatory practices and with fundamental principles of finance.

cent would result in an over-all rate of return of almost 6¾ percent.[6]

The chart on page 23 of Exhibit 13 is based on adjusted rates of return on common equity to reflect the increase in pure cost of money which has been experienced since the year of the particular Commission decision shown on that chart. But even if no adjustment whatsoever is made to the returns on equity granted by the Commission, the return on Tennessee's common equity would be 11.5 percent, if Tennessee is to be allowed the same return granted to other pipelines on their equity capital, equity ratios considered. A chart prepared in the identical manner as the chart on page 23 of Exhibit 13, but reflecting the unadjusted returns to equity shown in Column 5 of page 22 of Exhibit 13, is attached as Appendix A. The return to equity of 11.5 percent indicated thereon for an equity ratio of 29.5 percent would produce an over-all return to Tennessee of 6.53 percent.

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Appendix A also shows that the allowances on common equity of 10.35 percent to Manufacturers and 10.18 percent to Southern are consistent with Commission practice, whereas the allowance of 10.12 percent on the thinner equity of Tennessee materially departs therefrom.

The foregoing, we submit, indicates clearly that the return allowed on Tennessee's common stock equity is not commensurate with the returns recently allowed other pipeline companies, particularly after giving consideration to differences in risks resulting from differences in the thickness of the common equity. Accordingly, by this test

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[6] Even the Commission's Staff did not recommend a rate of return on Tennessee's common equity capital as low as the 10.12 percent allowed by the Commission. The Staff, it will be recalled, recommended, in its brief, a 10.41 percent return on Tennessee's common equity.

alone, it is abundantly clear that the Commission's action in allowing Tennessee only a 6⅛ percent over-all return deprives Tennessee of property without due process of law, and arbitrarily discriminates against Tennessee.

Returns Earned by Electric Companies

As demonstrated by the record herein (Exh. 14, pp. 4-5) the electric industry, as a whole, has, in recent years, been earning, under rate regulation, a return of about 11 percent on a common equity ratio *thicker* than that of Tennessee. Thus, in 1958, the electric industry earned 10.97 percent on its common equity; in 1957, it earned 10.96 percent; in 1956, it earned 11.04 percent; in 1955, it earned 10.92 percent. Indeed, in only one year (1951) in the past ten years, did the electric industry earn less than 10 percent on its common equity (Exh. 14, p. 5).

The unchallenged and unrefuted evidence of record shows conclusively that electrics are considered by investors as a less risky business than gas pipelines (Tr. 167-9). And this is wholly apart from the fact that electrics generally have thicker common equity ratios than Tennessee (and the pipeline industry generally).

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The Commission, in the order here involved, stated (p. 7):

> "There is likewise no substantial evidence to support Tennessee's contention that it needs a 14 to 15 percent return on common equity because certain electric utilities have had an average return of almost 11 percent over a period of years. We are not convinced that the selection of electric utilities made by Tennessee presents a proper basis for comparison, or that the differing risks inherent in the two industries

can be measured as Tennessee here proposes. It is significant to note that according to Tennessee's own study, the three largest electric utilities for which data is shown—namely, Consolidated Edison Company of New York, Pacific Gas and Electric Company and Public Service Electric and Gas Company—had earnings on common equity for 1958 of 8.1, 9.7 and 8.6 percent, respectively."

The statement quoted above is replete with error and is contrary to the record. For example, Tennessee does not contend that it needs a 14-15 percent return on common equity. It contends that it needs a return on common equity of approximately $12\frac{1}{2}$ percent. Reference to the record herein (Exh. 34) shows that on Tennessee's corporate capitalization as of March 31, 1960, it was claiming a return on its common equity of 12.52 percent.[7] Reference to Tennessee's brief herein also shows that Tennessee is claiming only a $12\frac{1}{2}$ percent rate of return on its common equity (See, for example, pp. 11, 12, 27).

Tennessee's claimed return of approximately $12\frac{1}{2}$ percent on its common equity recognizes the fact that a thicker common equity justifies a lower return thereon than the returns of 14-15 percent heretofore allowed Tennessee by the Commission. Thus, on page 27 of its Brief, Tennessee stated:

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"Tennessee, however, recognizes that a thicker equity does not require as high a rate of return as does a thinner equity, due to the lesser risk to the common stock investors. In the instant proceeding,

[7] Exhibit 34 shows an equity ratio of 32.03 percent. This ratio includes as common equity the $17,463,700 of the 4.5 percent series of convertible second preferred stock outstanding as of March 31, 1960.

> Tennessee, as previously shown, has succeeded in thickening its common equity from the range of 20%-27% in its previous cases to 32.00% as of March 31, 1960. We seek no reward for such action. On the other hand, we do not want to be penalized therefor. Tennessee is requesting in this case only 12.52% return on this thicker equity, as contrasted to the 14%-15% heretofore requested and received from the Commission. * * *"

Moreover, the Commission is in error when it states that "*certain*[8] electric utilities have had an average return of almost 11 per cent over a period of years." The fact is, as shown above, that the *average* of the *entire* industry has been about 11 percent on its common equity in recent years—a common equity significantly thicker than that of Tennessee.

The Commission, in the above quotation, points to the fact that three of the electric utilities for which information was shown in a Tennessee exhibit (Exh. 14, p. 4) had returns on equity in 1958 of 8.1, 9.7 and 8.6 percent, respectively. But the exhibit contains information pertaining to 25 electric utilities. Eighteen of those companies earned more than 11 percent on their common equities—common equities[8] which in every single case were also *thicker* than Tennessee's. We submit that selecting the three companies which had the lowest returns on common equity is arbitrary and does not constitute a valid or fair comparison under the principles enunciated by the Supreme Court in the *Bluefield* and *Hope* cases, *infra*. Tennessee is legally entitled to earnings commensurate with earnings in other enterprises having corresponding risks. This should not, and cannot legally, be interpreted as meaning that Tennessee

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[8] Emphasis supplied.

is entitled to earnings commensurate with the lowest rate of earnings being earned by three selected companies.

The Commission questions the propriety of selecting the electric industry as a basis for comparison, and also questions (in the quotation above) whether the differing risks inherent in the electric and pipeline industries can be measured "as Tennessee here proposes." But the record contains specific, unrefuted, and unchallenged expert testimony by one of the leading investment bankers in the country that electrics are regarded by investors as being comparable with the natural gas industry, except that the *natural gas industry is regarded as having somewhat greater risks than the electric industry* (Tr. 167-9). Indeed, it is a matter of common everyday knowledge that electrics are considered one of the least risky and most stable utilities in the country. The comparison with the electric industry cannot arbitrarily be dismissed or brushed aside, we respectfully submit, simply because such comparison, by every reasonable standard, demonstrates that the return allowed to Tennessee by the Commission is too low.

Moreover, the return of 10.12 percent allowed Tennessee on its common equity is not only unsupported by the record and by appropriate findings, but flies directly in the face of the record. *It is lower than that actually being earned by the electric utility industry. It is lower than the average earned since 1951 by the 10 major pipelines in the country* . (See Exh. 22). Indeed, *it is substantially lower than the average* (12.4%) *earned in the past several years on common equity by the entire natural gas industry regulated by the Commission* (Tr. 1499; See Statistics of Natural Gas Companies, 1958 edition, p. XII, issued by Federal Power Commission).

The foregoing further serves to show that the return allowed Tennessee on its common equity deprives it of property without due process of law, is contrary to the evidence of record, is unsupported by the record and by appropriate findings of fact in violation of Section 8(b) of the Administrative Procedure Act (5 U.S.C. 1007 (b)), and is arbitrary and capricious.

Use of Earnings-Price Ratios

The Commission (on page 5 of its order) refers to various earnings-price ratios for Tennessee and the pipeline industry generally and states that earnings-price ratios "may properly be used with judgment, together with other factors," in determining a reasonable allowance on common equity. The Commission concludes that Tennessee's earnings-price ratios over the past 12 years compare favorably with those of the other major pipeline companies, and are generally equal to or lower than those of the industry as a whole. Such a conclusion, we respectfully submit, in no way supports the propriety of the 10.12 percent return allowed Tennessee on its equity. Moreover, such conclusion is unsupported by appropriate findings indicating the use to which the earnings-price ratios were put in order to arrive at the 10.12 percent return on common equity.

The mischievous—indeed, the extremely dangerous and erroneous—aspect of the blind and indiscriminate use of earnings-price ratios in the natural gas pipeline field is the apparent assumption that such ratios are a direct measure of a fair and reasonable return on the *book value* of the common equity. In all the experience of Mr. L. E. Katzenbach, a general

partner of White, Weld & Company,[9] he has never encountered a single responsible investment officer of any trust company, insurance company, mutual fund, pension fund, or any other manager of investment funds, who employed any such philosophy (Tr. 1446-7).

The fact is that earnings-price ratios do *not* measure what it takes in the form of earnings on *book value*, as distinguished from market value, to attract equity capital. This fact can be demonstrated by a simple example. Thus, the stocks of most natural-gas transmission and distribution companies and of most electric light and power companies sell at prices materially in excess of book value (Tr. 1447). Assume, for example, that a company's common stock sells at a price of $34.00, that its most recently reported earnings were $1.70 a share, and its book value $17.00 a share. In this example, the company is earning 10% on its book value and its stock is selling at an earnings-price ratio of 5 percent. The Commission's earnings-price ratio theory of fixing return on common equity erroneously assumes that the investor who pays $34.00 per share, thereby establishing an earnings-price ratio of 5 percent, is satisfied with a 5 percent rate of return on *book value*, which return amounts to only about 2½ percent on his investment. This means that although the company earned $1.70 a share last year, the investor would be content if the company earned 5 percent on its $17.00 book value, or 85¢ per share, in the future. Obviously, investors are not so lacking in common sense.

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[9] White, Weld & Company, during the past five years, has acted as the managing underwriter or as the co-manager of public offerings of corporate securities aggregating more than three billion dollars. It is generally considered to have a broader familiarity with, and experience in, the natural-gas pipeline field than any other firm in the country (Tr. 151-2).

Conclusive proof of the fallacious nature of earnings-price ratios is readily apparent in this record. Thus, the average earnings-price ratios of the 10 natural gas companies used in the Staff's exhibit was, for the years 1953 to 1958, 6.58 percent (Exh. 21, p. 37). The *actual* earnings, however, of the 10 companies on their common stock book equities for that period was 15.6 percent (Exh. 22). In other words, if earnings-price ratios are an actual measure of the "cost" of equity capital, the Commission has been more than 100 percent wrong in its previous allowances on equity capital. The plain answer is that the earnings on the equities—earnings which have been the basis of the sales of millions of dollars of common stocks—are sound and that the use of earnings-price ratios as a measure of the "cost" of equity is basically wrong.

Exhibit 21, pp. 11-15, shows that in very recent years the bonds and debentures of natural-gas pipeline companies have been selling to yield in the neighborhood of 5.0-6.0 percent. Corporate bonds generally had a yield of 4.65 percent in 1959 and U.S. Government long-term securities had a yield of 4.07 percent in the same year. Moody's Aaa bonds had a yield of 4.49 percent in 1959. On the other hand, the dividend yield on Standard and Poor's 500 common stocks was 3.23 percent in 1959, while the yield on the 10 natural gas common stocks selected by the Staff ranged from 2.5 percent to 4.9 percent in 1959 (Tr. 1097-9; Exh. 21, pp. 23-32). This is proof positive that natural gas common stocks are not purchased for current yields and earnings, as the Commission erroneously assumed.

Even earnings-price ratios, the record shows, are less, in many cases, than the yields on Aaa bonds. Thus, the aver-

age earnings-price ratio in 1959 on Tennessee's common stock was 5.0 percent. During the

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month of July, 1959, the earnings-price ratio on Tennessee's common stock was 4.5 percent (Exh. 23). The earnings-price ratios on common stocks of other natural-gas pipeline companies were similarly low. Thus, for the 12 months ended September 30, 1959, the earnings-price ratio on El Paso's and Southern Natural's common stock was 5.1 percent. The composite earnings-price ratio of the ten larger natural gas pipeline stocks was 6.0 percent (Exh. 21, p. 38). The highest earnings-price ratio on Tennessee common stock was 8.5 percent in 1948. In only three years since then did the earnings-price ratio exceed 7 percent, namely, 1949, 1951 and 1953. In every other year, the earnings-price ratio was less than 7 percent. The average for the years 1948-1959 was 6.5 percent (Exh. 21, p. 29).

Still further evidence of the treacherous nature of earnings-price ratios for use in determining proper allowances for common stock equity may be found by comparing earnings-price ratios of electric utilities with the actual earnings of such utilities. The earnings-price ratios for Moody's 24 electric utility common stocks for the years 1952 to 1958, inclusive, was 6.61 percent (Exh. 13, p. 15). However, the earnings on common equity of electric utilities in the United States, according to Statistics of Electric Utilities for 1958, published by the Federal Power Commission, averaged 10.9 percent (Table 5, page XII). This disparity clearly shows that earnings-price ratios are not, and cannot be, used as a basis for the fixing of electric utility rates.

Dr. Shaffner, the Staff witness, stated (Tr. 1013) that earnings-price ratios should "be used with judgment and discretion," and that they "should not be used on a spot

basis, or on a basis of transitory and untypical conditions." In times like the recent past, Dr. Shaffner testified,

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"they should be considered as the minimum return which it takes to attract equity capital, as a floor, so to speak." Mr .Katzenbach, on the other hand, categorically stated (Tr. 1451) that they should not be used at all "because the premise that earnings-price ratios are indicative of the rates of return on common stock equity—that is to say, book value—necessary to attract capital is mistaken."

The 1958 report of the Committee on Corporate Finance of the National Association of Railroad and Utilities Commissioners (NARUC) clearly supports Mr. Katzenbach. Thus, that report categorically states that "the use of low current earnings-price and current dividend price ratios are meaningless as a measure of investor expectations, and, therefore, inadequate as a measure of the cost of common stock equity" (Tr. 1114-5).[10]

The foregoing, we submit, demonstrates that the Commission's reliance on earnings-price ratios to support the return allowed on Tennessee's book equity of 10.12 percent is misplaced and is unsupported by the record herein and by appropriate findings of fact. Its order is, therefore, in violation of Section 8(b) of the Administrative Procedure Act (5 U.S.C. 1007(b)).

Coverages

The Commission (p. 7 of order) observed that there is "no substantial evidence to show that such coverage ratios must be maintained at levels

[10] In this connection the study of the West Virginia Commission witness, referred to in the order here involved, was confined to two brief periods, namely, the month of May, 1953, and a four-week period in 1960, and is, therefore, completely unreliable either for the purpose of determining "cost" of common stock capital or as corroborating the "cost" arrived at by the Commission.

comparable to those of 1954 and prior years, nor is there evidence of comparability with other companies and industries to show that the quality of Tennessee's senior securi-ties will suffer in the market place if Tennessee is not given the 7 percent rate of return which it seeks." The Commission is in error.

The record contains unrefuted and unchallenged testimony on the matter of coverage ratios by an eminently qualified expert witness, Mr. Katzenbach (Tr. 151-2; Tr. 160-4). Mr. Katzenbach, after discussing the decline which has taken place in Tennessee's coverage ratios, testified (Tr. 163-4)

> "I know from first-hand experience in dealings and negotiations with investment officers of institutions which represent the market for, and from whom the funds must come for the new issues of debt securities, that the maintenance of adequate margins of coverage of interest requirements and sinking fund payments is a matter of prime importance and that if these margins of coverage are allowed to deteriorate further, the result would be a definite downgrading in the investment quality of Tennessee's securities in the eyes of investors.
>
> "This can only lead to a situation where Tennessee is placed at a disadvantage with respect to the terms upon which it can obtain additional capital for its future expansion. The figures and computations shown on pages 2 and 3 of my exhibit [Exh. 14] may seem a trifle theoretical but the problem is not a theoretical one by any means. The figures and computations merely serve to demonstrate that a 7% return under present conditions is no more than sufficient to maintain the standard of financial soundness which Tennessee was able to present to investors in past years."

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The foregoing, we submit, shows clearly that the Commission's conclusions as regards coverage ratios is contrary to the unrefuted and unchallenged evidence of record.

Thickening of Tennessee's Equity

As shown by page 14 of Exhibit 13, Tennessee's equity has varied from 27.75 percent in 1946 to 19.80 percent in 1954. Recently, however,

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Tennessee has succeeded in thickening its equity to a ratio of approximately 30 percent. That the thickening of equity is desirable is attested to by the Commission's decision in the *El Paso* case (Opinion 278) wherein the Commission, in allowing El Paso a return on equity of 14.4%, observed (*mimeo.*, p. 38) that such return "should permit and encourage it to make further improvement in its capital structure." In the last decided Tennessee rate case (Docket G-5259) wherein Tennessee was allowed a return on equity of 13.71%, it was observed (18 F.P.C. at p. 441—decision issued October 17, 1957) that Tennessee's common equity ratio, which was 21.80 percent as of the end of 1955 "should be improved."

In the *Manufacturers* case, *supra*, the Commission observed (23 F.P.C. at p. 448) that Columbia (which does all the financing for Manufacturers, its subsidiary) "has commendably continued its practice of maintaining a conservative capital structure with no undue thinning of the equity." The Commission further observed that "the public interest would be best served by encouraging this practice.

And in the *Southern* case, *supra*, the Commission pointed to the fact that:

> "Southern has maintained a conservative capital structure without undue thinning of its equity, where-

as the industry as a whole has frequently resorted to high leverage financing in order to maintain profit levels, and we have consistently held the public interest is best served by allowing a return on equity which encourages such conservative financial structures."

But does the $6\frac{1}{8}$ percent return allowed Tennessee encourage Tennessee to continue its recent practice of thickening its equity? Patently not. Thus, if Tennessee were to increase its common equity ratio to 40% (the common equity ratio of Manufacturers) *the resulting return*

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on Tennessee's equity ratio of 40 percent would be only 8.61 per cent. The computation is as follows:

Debt and Preferred Stock	60%	× 4.45%[11]	=	2.67 %
Common Equity	40%	× 8.61%	=	3.445%
Total				6.125%

If Tennessee were to increase its common equity ratio to the level of Southern's, namely, 36%, the $6\frac{1}{8}$ percent return allowed Tennessee would result in a return on such thicker equity ratio of only 9.1%. The computation is as follows:

Debt and Preferred Stock	64%	× 4.45%	=	2.85 %
Common Equity	36%	× 9.10%	=	3.275%
Total				6.125%

The foregoing, we submit, makes crystal clear the fact that the return allowed Tennessee discourages the very thickening of the equity which the Commission seeks to

[11] Weighted average cost of Tennessee's debt and preferred stock capital (derived from pp. 3 and 4 of order of August 9, 1960).

encourage. The foregoing also serves to demonstrate still further the confiscatory, discriminatory and arbitrary nature of the Commission's rate of return allowance to Tennessee.

Minimum Bill Provision

The Commission found (p. 6 of order) that "Tennessee has a relatively low risk in connection with the recovery of its cost of service by reason of the minimum bill provisions of its rate schedules guaranteeing at least 69.5 percent of its estimated revenues from jurisdictional business." Such finding is erroneous, insofar as it implies that whatever

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lesser risk exists should be reflected in a lower return on Tennessee's common equity.

In the first place, there is no evidence in the record as to minimum bill provisions of other pipeline companies and of electric utilities. Accordingly, the relative risk cannot be measured. Secondly, the Staff witness who testified as to the minimum bill provision admitted that he did not know whether the minimum revenues would even cover fixed and operating expenses (Tr. 1227). Finally, to the extent that the minimum bill provision is a factor considered by investors it is already reflected in the return requirement on common equity capital and in the interest rates and dividend rates on senior securities (Tr. 1159-60).

Gas Reserves

The Commission also found (p. 6 of order) that "Tennessee's position is further strengthened by its rapidly increasing gas reserves, these reserves having increased 63 percent since 1950 as compared to an increase of 36 percent for the nation's reserves for the same period." This finding, however, is misleading. Patently, gas reserve figures are meaningless unless such reserve figures are

compared with requirements. The record shows, in this regard, that the reserve life index of Tennessee gas reserves has decreased from 34 years in 1947 to 24 years in 1956. (Item A, pp. 3463-7).

Test of Bluefield and Hope Cases

In the *Bluefield* case (262 U.S. 679) the Supreme Court stated the test of a fair rate of return as follows:

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"A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."

In the *Hope* case (320 U.S. 591) the Supreme Court stated:

"* * * the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital."

The 6⅛ percent over-all return (and the 10.12 percent return on common book equity) clearly do not meet the test of the *Bluefield* and *Hope* cases. The return allowed Tennessee will *not* enable it to earn a return on its property "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties." This is apparent from the fact that, as previously shown, the return allowed Ten-

nessee is substantially less than that being earned by, and being allowed to, other business undertakings attended by corresponding risks and uncertainties.

Tennessee claims no vested right in the 14-15 percent returns heretofore consistently allowed to it by this Commission. But Tennessee, as well as the tens of thousands of investors in its securities, have the right to expect the Commission to protect the integrity of the investments they have made in Tennessee. Those investors have the right to expect that the increased cost of debt incurred in expanding the system to meet the needs for natural gas would be offset by appropriate allowances in the rate of return. Those investors have the right to expect that they will be treated as fairly as investors in other pipeline companies and other

regulated companies. Those investors had the right to expect consistent regulatory policy as to all companies. Those investors also had the right to expect that in a period of time when practically all costs, including the cost of money, have gone up, the Commission would not arbitrarily reduce earnings on their common book equity by approximately one-third.

"Financial Integrity"

The Commission concludes (p. 7) that the rate of return allowed Tennessee is sufficient to "preserve" Tennessee's "financial integrity." Such conclusion is not supported by substantial evidence and adequate findings. A finding of financial integrity cannot be made in a vacuum. Yet, the Commission has done precisely this. The Commission has deferred for later hearing and determination the rate of return applicable to Tennessee's production properties, stating (at p. 7) that "final determination of the proper rate of return on production properties cannot be made

at this time, but will be made upon conclusion of the next phase of the proceeding." It is thus clear that the Commission cannot, on the basis of the present record, determine whether the $6\frac{1}{8}$ percent over-all rate of return which it has allowed is fair and reasonable and sufficient to preserve the financial integrity of Tennessee (See *El Paso Natural Gas Company* v. *Federal Power Commission*, No. 18022, 5th Circuit, Decided August 2, 1960). For example, if the Commission were to find, as we believe it must, after completing the next phase of the proceeding, that Tennessee is entitled to a higher rate of return than $6\frac{1}{8}$ percent on its production properties, how could Tennessee recover such additional return retroactively after having made refunds to its customers on the basis of a $6\frac{1}{8}$ percent return pursuant to the interim order?

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There are other important issues not yet fully heard which vitally affect the question of whether the return of $6\frac{1}{8}$ percent is adequate to protect the financial integrity of the company. For example, until the Commission has fully heard and decided the depreciation issue in this case, it cannot make an appropriate cash flow study to determine whether Tennessee will have sufficient cash to pay interest on its bonds, dividends on its preferred stock and meet the sinking fund requirements on its securities.

The Commission cannot, therefore, now make the finding that the rate of return allowed Tennessee will "preserve its financial integrity." Moreover, it is difficult to perceive how a rate of return lower than the returns being earned by, and being allowed to, more secure regulated business enterprises can preserve the financial integrity of Tennessee, and enable it to attract capital on comparatively favorable terms and conditions.

Other Errors

In arriving at the rate of return allowed to Tennessee, the Commission utilized a consolidated capitalization which reflected the capitalization ratios and cost of capital of Tennessee and its subsidiaries as of February 29, 1960 (p. 3). In so doing, the Commission erred in failing to reflect and take into consideration the financing of Midwestern Gas Transmission Company which has been consummated pursuant to a plan heretofore submitted to, and approved by, the Commission. As the Commission was aware at the time it issued its order herein, Midwestern issued and sold $60,000,000 of first mortgage bonds at a coupon rate of 5¾ percent

with a net cost to the company of 5.92 percent.[12] Yet, the Commission used a capitalization reflecting the former cost of debt capital to Midwestern which consisted of a bank loan of $35,000,000 with a cost of 5.07 percent, which loan has been retired.

The Commission further erred in refusing to treat as common equity the $19,264,000 of 4.50 percent series of convertible second preferred stock which, as of February 29, 1960, had not been converted into common stock (p. 4 of order). In so doing the Commission ignored the rapid rate at which conversion is taking place and also ignored the fact that the very purpose of issuing convertible second preferred stock is to thicken the equity in the most economical manner. The rapidity at which conversion is taking place is evidenced by the fact that by March 31, 1960, the amount of the 4.50 percent series of convertible second preferred stock which remained to be converted was $17,463,700 (Tr. 1505); during April, 1960, an additional

[12] This matter was referred to in Tennessee's brief in this proceeding at page 6.

$1,768,500 was converted, leaving less than $16,000,000 outstanding as of the end of that month (Tr. 1505); and by the end of July 31, 1960, only $13,262,200 remained to be converted.

These facts must appropriately be recognized and given full effect, particularly in a case such as this where rates are being fixed for the future. In cognate circumstances the Commission gave effect to imminent future changes in the cost of capital of Southern Natural Gas Company in its interim order issued July 8, 1960 at Docket G-20509, wherein the Commission stated (at p. 4):

"* * * The *pro forma* adjustment of the weighted average cost of debt as of December 31, 1959, to reflect the retirement of the bank notes and the issuance of long-term debt securities to replace them is proper in this case where we are determining rates for the future and where the funding of such loans in the very near future is reasonably to be expected and such funding is consistent with good practice. We therefore find Southern's cost of debt capital to be 4.45 percent, as determined by both Southern and staff."

The Commission's refusal to accord similar treatment to Tennessee is but another example of the discriminatory character of the Commission's order.

We respectfully urge the Commission, in the light of all of the foregoing, to reconsider its order herein of August 9, 1960, and upon such reconsideration to allow the 7 percent rate of return claimed herein by Tennessee.

II

Interim Rate Reductions and Refunds

The order here involved disallows the rates presently in effect, permits Tennessee to file substitute rates, effective

as of April 5, 1960, reflecting a $6\frac{1}{8}$ percent rate of return, and requires Tennessee to refund to its jurisdictional customers the difference between the presently-effective rates and the substitute rates. The order also requires Tennessee to accompany its substitute filing "with supporting cost of service and allocation data, to be computed and presented in the same form and manner as continued in its exhibits heretofore offered by it in this proceeding, revised only to reflect a $6\frac{1}{8}$ percent rate of return and Federal income taxes associated therewith." (p. 10 of order)

The Commission's disallowance of the presently-effective rates and its requirement that reduced rates be filed and refunds made is unlawful

and inequitable. But even assuming *arguendo* that the Commission has the legal authority to require interim rate reductions and refunds, such requirement, in the circumstances of this case, constitutes a flagrant abuse of discretion.

The Commission points out in its order (p. 8) that Tennessee contends that the interim order procedure is unlawful and inequitable unless the Commission makes final disposition of the issue of cost-allocation and rate design at the same time it determines the proper rate of return, "since Tennessee may not be able to recover its cost of service should the Commission decide these issues in such a way that Tennessee would have to make refunds in certain zones where its rates are found to be too high but could not recover revenues retroactively in those zones where it has charged less than the finally determined cost of service."

The Commission then dismisses this contention by quoting with approval from its order in the *Southern* case wherein it stated that:

"Should Southern suffer legal injury by reason of the Commission's final order in the second phase of this proceeding, it may seek judicial review. It cannot, however, be heard to complain of an order which fixes a proper rate of return and looks only to the establishment of interim rate levels based on such proper return and which in all other respects are based on the methods and procedures employed by Southern in making its rate filing, including its own allocation and rate design methods."

But Tennessee files rates. It does not file cost allocations or rates of return. To be sure, cost allocations and claimed rates of return are submitted with rate filings. But it is the level of the rates which is significant from the rate-making standpoint. If the level of a particular rate is reasonable judged by such method of cost allocation as may be ultimately adopted by the Commission, it makes no difference

that the particular rate was predicated on a different method of allocation. Stated differently, until and unless the Commission determines the method of allocation to be used for allocating costs among the six rate zones on the Tennessee system, it does not know, and cannot make the finding, that the rates in each and every zone are unjust, unreasonable, or unduly discriminatory.

Section 4(e) of the Natural Gas Act provides that "after *full hearings*, either *completed* before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective." Here, it is to be noted, full hearings have not been held or completed as to the reasonableness of the interim rates which the Commission requires Tennessee to

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file. One of the untried issues is the question of what rate of return shall be allowed on Tennessee's production (well mouth) properties. The Commission's order specifically defers this issue for later hearing. Until this issue is finally heard and disposed of, the Commission has no way of knowing whether the $6\frac{1}{8}$ percent over-all rate of return which it has allowed in its interim order is adequate for Tennessee. As pointed out elsewhere herein, if the Commission should later determine that Tennessee is entitled to a highe rrate of return than $6\frac{1}{8}$ percent on its production properties, Tennessee will be unable to recover such additional return. The Commission's order, therefore, deprives Tennessee of due process of law in failing to afford Tennessee a full hearing on this vital issue *before* entering its order reducing rates.

Section 5(a) provides that "Whenever the Commission, *after hearing* * * * *shall find* that any rate * * * is unjust, unreasonable;

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unduly discriminatory, or preferential, the Commission shall *determine* the just and reasonable rate * * * to be thereafter observed and in force, and *shall fix* the same by order: * * *." While the interim order purports to find that Tennessee's filed rates are unjust and unreasonable, the Commission cannot lawfully make a finding as to the reasonableness of the specific rates filed for each zone because it has not yet decided the allocation issue. This is so for the reason that the Commission has refused to determine what portions of the over-all cost of service (as reduced by the lowering of the rate of return from 7 percent to $6\frac{1}{8}$ percent) is properly allocable to each of Tennessee's six zones. Such reduced cost of service must be *allocated* to each of the separate zones and compared with the revenues yielded by the filed rates in each zone before the Commission can possibly know whether the filed rates are

higher or lower than the cost of service applicable to each zone. Such determination must be made by the Commission—it cannot be lawfully delegated to Tennessee—before the Commission can definitively find, as required by the statute, that the filed rates are too high, too low, or unduly discriminatory in any particular zone. It is, therefore, clear that the Commission's purported general finding of unreasonableness of Tennessee's filed rates is arbitrary, capricious and without warrant in law or fact.

By the same token, the Commission cannot lawfully *prescribe* rates for the various zones, as required by the provisions of the Natural Gas Act quoted above, until it first determines the method to be used for allocating the cost of service among Tennessee's rate zones and services. Indeed, the Commission's order wholly failed to enter the

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necessary statutory finding that the rates which it requires Tennessee to file are just and reasonable interim rates. It failed to make such finding because it could not do so since it has refused to adjudicate the issue of zone allocation.

The Commission's order requires Tennessee, under pain of forfeiting its entire rate increase, to file reduced rates based upon Tennessee's proposed method of cost allocation. Since the cost allocation issue is one of the most controversial issues in this case and had not yet been decided, the Commission has placed Tennessee in the precarious position of making refunds and charging interim rates to its customers at its peril pending a later decision by the Commission on the question of whether such refunds and interim rates are in fact just and reasonable. If the Commission should later decide that a method of allocation should be used other than the one used by Tennessee, then Tennessee may not be able to recover its total

cost of service, including even the meagre rate of return here allowed.

We respectfully submit that such a "heads-we-win-tails-you-lose" method of rate making is an abuse of discretion and does not measure up to the standards of fair play or due process of law.

As stated above, the allocation issue was fully tried over a period of three years, has been fully briefed, and has been ripe for decision for more than four months. What possible justification can there be under the circumstances for refusing to omit the intermediate decision and decide this issue before ordering Tennessee to reduce its rates. Surely, Tennessee should not be required to proceed in total darkness as to the Commission's views regarding allocation of costs—views which

must be known before a determination can be made as to which classes of customers in which zones are entitled to what rate reductions, if any. Under what theory of law, logic, or fair play should Tennessee be required to proceed at its own peril to make refunds and reduce rates under one method of allocation at the risk of being later told that a different method of allocation should have been used and that Tennessee must forfeit a large part of its cost of service because it made a wrong guess as to the allocation method which would eventually be adopted by the Commission.

Where cost allocation is not an issue in a case or where a future order of the Commission cannot operate retroactively in such a manner as to jeopardize the ability of a company to recover its cost of service, an interim rate reduction may be appropriate. That was the situation in the cases cited and relied upon by the Commission in the *Southern* order, *supra.* But cost allocation *is* an issue pending decision now by the Presiding Examiner in Docket G-11980. The Presiding Examiner has ruled that what

ever method of cost allocation is finally adopted in Docket G-11980 will be applicable in the instant docket (Tr. 453-6).

As stated above, if Tennessee is required now to reduce its rates and to make refunds, it will be placed in jeopardy of not being able to recover its cost of service if the method of allocation ultimately selected allocates more cost of service to a particular rate zone than the revenues produced by the interim rates.[13] It is no answer, we submit, to state that

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Tennessee may seek judicial review if it should suffer legal injury by reason of the Commission's final order in the *second phase* of this proceeding. It is no answer because it is the *instant* order which places Tennessee in jeopardy of not being able to recover its cost of service if refunds have already been made and the reduced rates have been collected.

Assuming *arguendo*, however, that the order here involved is legally appropriate from the statutory standpoint, we respectfully submit that the order, nevertheless, is invalid as constituting an abuse of discretion. As the Commission knows, Tennessee's customers are fully protected by Tennessee's undertaking in this docket to make refunds, with interest at 7 percent, of excess charges collected. As the Commission also knows, the well-being of a company depends on its ability to recover its cost of service. Why, we respectfully ask, should the Commission jeopardize the financial well-being of a company by an interim order such as is involved here? What emergency has arisen that requires the Commission to place Tennessee in such jeopardy? The desire for expedition of rate cases is, of course, commendable, and we fully support

[13] As pointed out in our Memorandum (pp. 7-8) in this docket filed with the Commission on June 13, 1960, the exposure to which Tennessee is subjected by the instant order involves several millions of dollars.

and likewise desire expedition. But the desire for haste must give way to the need to protect the rights and property of others.

Basic fairness, we submit, dictates that the Commission not require rate reductions and refunds until the allocation issue is also decided. This is particularly so in view of the fact that the Commission has not heretofore prescribed a method of allocation for use on the Tennessee system. We, therefore, urge the Commission, upon rehearing, to delete any provision requiring rate reductions and refunds until such

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time as the entire rate of return issue is fully heard and the allocation issue is finally decided.

WHEREFORE, in view of all the foregoing, it is respectfully urged that the Commission grant rehearing of its order issued August 9, 1960, as requested herein.

Respectfully submitted,

TENNESSEE GAS TRANSMISSION COMPANY
By /s/ HARRY S. LITTMAN
By /s/ JACK WERNER
Its Attorneys

William C. Braden, Jr.
B. J. Williamson
Tennessee Building
Houston 1, Texas
Harry S. Littman
Jack Werner
Harold L. Talisman
317 Wyatt Building
Washington 5, D. C.
Attorneys for Tennessee Gas Transmission Company

August 29, 1960.

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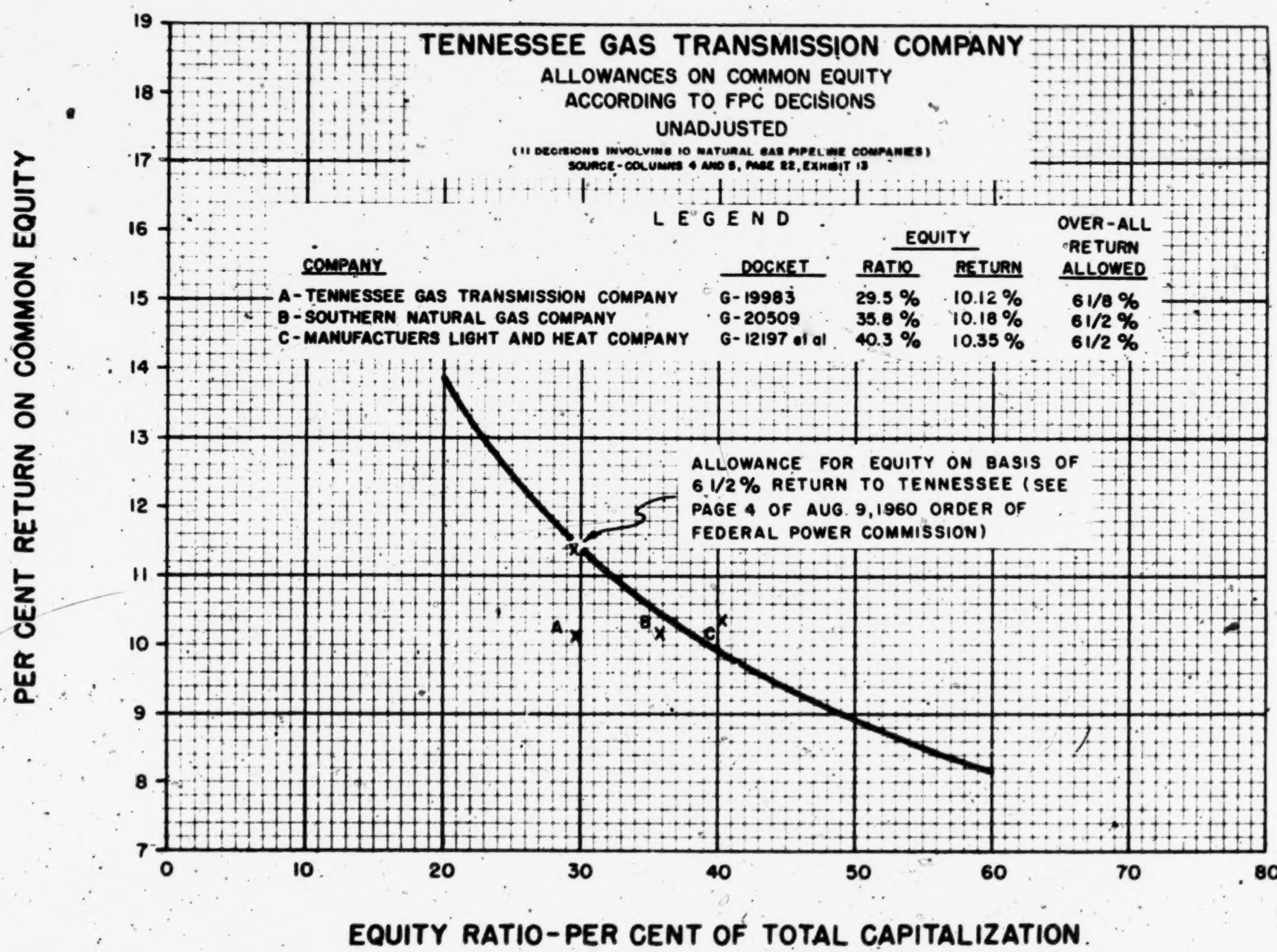

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APPENDIX A

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(Received Aug. 30, 1960)

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket No. G-19983

In the Matter of

TENNESSEE GAS TRANSMISSION COMPANY

Joint Application and Petition for Rehearing on Behalf of the Manufacturers Light and Heat Company, the Ohio Fuel Gas Company and United Fuel Gas Company So That the Commission Will Reconsider and Modify Its Order Issued August 9, 1960, Insofar As It Pertains to Interim Refunds.

Pursuant to Section 19 of the Natural Gas Act and Commission Rule 1.34; The Manufacturers Light and Heat Company, The Ohio Fuel Gas Company and United Fuel Gas Company ("Petitioners"), being aggrieved parties, hereby apply and petition for rehearing and request that the Commission reconsider and modify its order issued August 9, 1960, in Docket No. G-19983.

Petitioners urge that the Commission abrogate said order insofar as it requires Tennessee to make interim refunds to its jurisdictional customers effective as of April 5, 1960, prior to the final determination of *all* of the inseparable issues involved in the proceeding.

Petitioners urge this relief for the following reasons:

I. GROUNDS RELIED UPON BY PETITIONERS

1. *The Commission cannot reduce the rates charged by Tennessee in Zones 1, 5 and 6 without depriving Petitioners of rights created by Section 4 of the Natural Gas Act and Commission Rules 2.4 and 2.52.*

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Petitioners are substantial customers of Tennessee Gas Transmission Company ("Tennessee") in Tennessee's Rate Zones 2, 3 and 4. *Since 1947* Petitioners have been subjected to periodic increases in Tennessee's rates which have been *disproportionately* higher in Rate Zones 2, 3 and 4 than in the other rate zones of Tennessee. Petitioners have complained formally to the Commission that they have been subjected to undue rate discrimination by reason of Tennessee's undercharges to customers in its Zones 1, 5 and 6. The Commission has for many years recognized the existence of the issue of unlawful rates between zones and set Docket No. G-11980 as the proceeding in which to determine the basic controversy as to the principles and methods to be applied towards allocation of costs among zones and classes of service within the zones.*

In this context on October 5, 1959, Tennessee filed increased rates in *all* of its Zones 1 through 6, which rates are the subject of this proceeding, Docket No. G-19983.

Petitioners submit that this voluntary filing by Tennessee for higher rates in Zones 1, 5 and 6 created direct, real and substantial rights, interests and benefits to Petitioners and other customers of Tennessee in Rate Zones 2, 3 and 4. Petitioners submit that their legal rights so created are adversely affected by the Commission's interim refund order issued August 9, 1960. This stems, in part, from three undeniable premises; namely,

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1. Petitioners' have before the Commission a long-standing charge that Tennessee has violated Section 4(b) of the Natural Gas Act by subjecting Petitioners in Zones 2, 3

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* See Docket No. G-5259, orders issued October 6, 1955 and September 5, 1957; Docket No. G-11980, order issued April 30, 1959.

and 4 to undue rate discrimination, prejudice and disadvantage in favor of Tennessee's customers in other Rate Zones and classes of customers;

2. Section 5(a) of the Natural Gas Act specifically deprives the Commission of the power to order Tennessee to increase any of its filed rates; and

3. As one essential step in the rate making process, the Commission is determining the rates for each of the six Rate Zones of Tennessee on the basis of assigning portions of Tennessee's total cost of service to those customers responsible therefor.

Thus, the Commission's interim refund order prejudged and predetermined arbitrarily that the rates charged by Tennessee in its Zones 1, 5 and 6, pursuant to the Commission's order issued April 29, 1960, are *not* too low. Such action prejudices Petitioners, who have contended for years that said rates are too low, and once the rates have been reduced the Commission lacks the power subsequently to require them to be increased.

Petitioners' position is supported by Commission's Rules 2.4 (c)(2) and (3) and 2.52. Said Rules recognize that not only are rate *increases* suspendable, but also rate *reductions* and *discriminatory changes* are suspendable when filed by regulated companies. It is submitted that this rule

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recognizes the right of customers which are being subjected to undue rate prejudice or disadvantage to have "full hearings" under Section 4(e) of the Natural Gas Act before the Commission may order rate *reductions* to other customers which are being granted undue rate preferences or advantages in violation of Section 4(b) of the Natural Gas

Act. There can be no other explanation for the necessity or propriety of suspending rate *reductions.*

2. *Petitioners have been denied the opportunity to adduce evidence on cost allocation herein, which would support their contention that Tennessee's rates in Zones 1, 5 and 6 are too low and should not be reduced.*

At T. 302, 1235-1241, the Presiding Examiner ruled that he would not receive rebuttal evidence on the issue of cost allocation in Docket No. G-19983. The Examiner has only received evidence which follows the contested manner of cost allocation proposed by Tennessee. It is submitted that since cost allocation is an essential step in the rate making process herein, the Commission lacks the authority to reduce Tennessee's rates in Zones 1, 5 and 6 and deprives petitioners of their right to "full hearings" under Section 4(e) of the Natural Gas Act and Section 7(c) of the Administrative Procedure Act.

3. *The Commission's interim refund order aggravates and complicates the rate controversy among the parties so as to be an abuse o fthe administrative process.*

As aforesaid, the Commission has set Docket No. G-11980 as the proceeding in which it will determine the prin-

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ciples and methods of cost allocation as a necessary step in determining the just and reasonableness of Tennessee's rates. It is submitted that the Commission's interim refund order short-circuits the procedure it has previously set as the framework for deciding the controversy. In addition, Petitioners' rights under Section 19 of the Natural Gas Act insofar as Docket No. G-11980 is concerned would be prejudiced by said interim refund order in Docket No. G-11983.

4. *The Commission's interim refund order herein erroneously relies upon its order issued July 8, 1960, in Southern Natural Gas Co., Docket No. G-20509, as a precedent and in turn sets an improper precedent contrary to the scheme of the Natural Gas Act.*

In its order issued in *Southern Natural, supra,* the Commission relied upon several administrative and judicial precedents. Petitioners submit that all of these so-called precedents are not apposite or are themselves contrary to law.

Petitioners submit that the long history of unresolved charges of undue rate discrimination distinguishes the instant case from *Southern Natural, supra.* All the other citations relied upon by the Commission are distinguishable from the Tennessee situation in that in those cases:

(1) The interim orders in those cases were "final" in the sense that they were not susceptible to retroactive adjustment by a subsequent order;

(2) No allocation issues were involved;

(3) The parties having rights determined by the interim orders had just had their "day in court" and a final determination of those issues.

II. Specification of Errors in the Commission Order Issued August 9, 1960

Underlying the above-stated grounds upon which Petitioners rely, it is submitted that the Commission's order issued August 9, 1960, included the following specific errors:

1. The Commission erred in its formal finding (2) that "The proposed increased rates filed in this proceeding

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> by Tennessee, . . . are excessive and should be disallowed,"

with particular respect to rates in Zones 1, 5 and 6.

2. The Commission erred in its formal finding (3) that "Tennessee should be permitted to file herein substitute lower rates satisfactory to the Commission . . . for the purpose of this interim order, . . . subject to refund in accordance with the Commission's order of April 29, 1960, and the undertaking heretofore filed by Tennessee in accordance with the terms of that order,"

with particular reference to rates in Zones 1, 5 and 6.

3. The Commission erred in its formal finding (4) that "Tennessee should be required to make prompt refunds with interest at 7 percent, in accordance with the Commission's order of April 29, 1960, and the undertaking heretofore filed by Tennessee, of all amounts collected by it from its jurisdictional customers subject to refund under its proposed increased rates. . .".

with particular reference to rates in Zones 1, 5 and 6.

4. The Commission erred in its ordering paragraphs (A), (B), (C) and (D) with particular reference to refunds, filings and rates for the future in Zones 1, 5 and 6.

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5. The Commission erred in its ordering paragraph (G) and in its statements on pages 8 and 9 of the narrative recital of the order to the effect that the order is without prejudice to Petitioners and that Petitioners (and those similarly situate in Zones 2, 3 and 4) will be in the same position as they would have been under hypothetical conditions which are contrary to fact. To the contrary, Peti-

tioners are prejudiced by the interim reduction of rates in Zones 1, 5 and 6. Moreover, Tennessee filed its initial rates on the basis of a 7 per cent rate of return, and not a 6½ per cent rate of return so that the Commission's hypothesis is contrary to fact, and as a result of said filing in Zones 1, 5 and 6 Petitioners derived an advantage under Section 4(e) of the Natural Gas Act as to their long-standing charge of undue rate preferences to certain of Tennessee's Zones.

6. The Commission erred in its statements on pages 7 and 8 to the effect that the propriety and legality of ordering Tennessee to make immediate refunds to customers in Zones 1, 5 and 6 had been settled in its recent *Southern Natural, supra,* order issued July 8, 1960.

7. The Commission erred in establishing a precedent herein which is contrary to the Natural Gas Act, the Administrative Procedure Act, and Constitutional guarantees of due process of law.

Respectfully submitted,

Brooks E. Smith
Brooks E. Smith
Attorney for
The Manufacturers Light and Heat Company
The Ohio Fuel Gas Company
United Fuel Gas Company

Of Counsel:

Brooks E. Smith
James G. O'Neill
120 East 41st Street
New York 17, New York
Attorneys for
The Manufacturers Light and Heat Company
The Ohio Fuel Gas Company
United Fuel Gas Company

William Anderson
John P. Egan, Jr.
800 Union Trust Building
Pittsburgh 19, Pennsylvania
Attorneys for
The Manufacturers Light and Heat Company

W. F. Laird
Ralph N. Mahaffey
99 North Front Street
Columbus 15, Ohio
Attorneys for
The Ohio Fuel Gas Company

R. K. Talbott
Herbert W. Bryan
Post Office Box 1273
Charleston 25, West Virginia
Attorneys for
United Fuel Gas Company

Dated: August 29, 1960

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(Docketed Sept. 27, 1960)

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Before Commissioners: Jerome K. Kuykendall, Chairman; Frederick Stueck, Arthur Kline and Paul A. Sweeney.

Docket No. G-19983

TENNESSEE GAS TRANSMISSION COMPANY

Order Denying Applications For Rehearing

(Issued September 27, 1960)

Applications for rehearing of the Commission's interim rate order issued August 9, 1960, in the above proceeding, have been filed by Tennessee Gas Transmission Company (Tennessee) and jointly by Manufacturers Light and Heat Company, The Ohio Fuel Gas Company and United Fuel Gas Company (Interveners).

Tennessee's application is directed to the allowance on common equity which the Commission found to be proper in determining the fair, just and reasonable rate of return to Tennessee for the purpose of the interim order, and to the interim rate reduction and refund provisions of the interim order. Interveners' application is directed only to the interim rate reduction and refund provisions of that order.

Tennessee's proposed increased rates in this proceeding are based on a proposed overall rate of return of 7 percent. When filed, the proposed 7 percent rate of return was based on an allowance for common equity of 14 to 15 percent, which Tennessee contends has been the historical return on its book equity under Commission regulation. In February of 1960, subsequent to its filing in this proceeding,

Tennessee issued additional common stock which had the effect of increasing the percentage of common equity in Tennessee's capitalization, and reducing the allowance on common equity produced by the proposed 7 percent rate of return to about 12½ percent, as computed by Tennessee. Tennessee did not thereafter propose any increase in its allowance on common equity, standing on the 12½ percent as equivalent to its historical return on the basis of this thicker equity.

In our interim order of August 9, 1960, we found an allowance of between 10 and 10.5 percent on common equity to be fully adequate for Tennessee, and sufficient to enable it to attract new equity capital and preserve its financial integrity. We thereupon fixed a fair, just and reasonable overall rate of return of 6⅛ percent which, on the basis of the cost of debt and preferred stock and the capitalization ratios therein found to be proper for the purpose of the interim order, will produce for Tennessee an allowance on its common equity of 10.12 percent. Tennessee, in its application for rehearing, charges that our action in this respect was arbitrary and capricious, deprives it of property without due process of law, and discriminates against it in favor of other

pipeline companies for which we have recently fixed rates of return. Tennessee cites our recent action in *Manufacturers Light and Heat Company*, 23 F.P.C. 446, February 25, 1960, and *Southern Natural Gas Company*, Docket No. G-20509, July 8, 1960, where, it contends, we allowed returns on common equity higher than that allowed Tennessee, and where the common equity was thicker than the common equity of Tennessee.

Tennessee states that in the *Manufacturers* case we allowed a return on common equity of 10.35 percent on an

equity ratio of 40.3 percent. On the contrary, we there found that a 6¼ percent rate of return was adequate for the period ending April 8, 1959, and that on the basis of a capital structure as of April 30, 1959, consisting of 59.7 percent debt and 40.3 percent common equity, and a cost of debt of 3.91 percent, an overall rate of return of 6¼ percent produced a 9.73 percent return on equity. We found that "a fair return on equity . . . should continue to approach 10 percent" and that since a 6¼ percent rate of return would not continue to produce a return on equity approaching 10 percent, because of the sharply increased cost of debt during 1959, a 6½ percent rate of return which would produce a return on equity of around 10 percent should be allowed for the rates after April 8, 1959.

In the *Southern* case, as Tennessee states, we allowed a return on common equity of 10.18 percent. And as Tennessee also states, Southern's capital structure there consisted of 64.2 percent debt and 35.8 percent common equity. However, there is nothing inconsistent in our action in that case and in the present case. A lower equity ratio does not necessarily demand a higher rate of return as Tennessee contends. It may well be true that a high leverage condition with a thin equity is indicative of a greater risk than a low leverage, thick equity situation. But the equity ratio is only one element or factor to be considered in appraising the risks associated with the common equity of any given company, and certainly no mathematical measure of differences in risk can be derived from comparing the equity ratios of different pipeline companies. The total capital structure, including debt and preferred stock ratios as well as common equity, the stability of earnings, and the historical pattern of growth of a company are all factors to be considered in appraising risk and determining a proper allowance for common equity. Neither Manufacturers nor Southern has preferred stock

in its capital structure, and neither has had the history of growth which Tennessee has had.

In our order of August 9, 1960, in this proceeding, as well as in other recent orders, we have stressed the variety of factors which must be considered in determining the allowance for common equity. Our finding that an allowance on Tennessee's common equity of between 10 and 10.5 per cent is adequate and proper is not based solely upon the evidence of earnings-price ratios, nor have we assumed, as Tennessee would believe, that such ratios are a direct measure of a fair and reasonable return on the book value of the common equity. Such ratios are, however, an indication of the investor's appraisal of the risks inherent in an enterprise and the return he requires in the light thereof. as we have stated before, such ratios may properly be used with judgment, together with other factors, in determining a reasonable allowance on common equity.

One such other factor is earnings on book equity, and Tennessee relies heavily in support of a higher allowance for equity on evidence of such earnings. We have given due consideration to this evidence as a factor in our determination of the allowance to be made, although such return cannot be taken as a direct measure of the allowance for equity. Such return includes contingent earnings under rates subject to refund in proceedings before the Commission. To fix a rate of return for the future on the basis of the historical return on book equity as Tennessee urges would be improperly to validate such contingent earnings.

The determination of a proper allowance for common equity is peculiarly a matter of judgment for the Commission. A rate of return cannot be a matter of slide rule computation. Consideration must be given to a multiplicity of factors, some of which cannot be isolated and objec-

tively measured and weighed, yet which, in the circumstances of any given case, may tip the balance one way or the other. In the present proceeding, we have considered all the evidence in arriving at our judgment of a fair and adequate allowance for Tennessee's common equity, and nothing in Tennessee's application for rehearing persuades us that our determination is incorrect or an improper exercise of administrative judgment.

In so affirming our interim order, we have also given consideration to, and we can find no sound basis for, Tennessee's charge that this determination will require Tennessee's stockholders to absorb virtually all of the increase in the cost of long-term debt incurred by Tennessee in the last five years. Tennessee has been able to maintain earnings on book equity at a fairly constant level during these years, and it appears that the increase in the cost of debt has been largely, if not completely, offset by Tennessee's ability to sell its common stock at prices well in excess of the book value of its stock. The record shows that Tennessee's common stock has been selling at about two and one-half times its book value. This further belies Tennessee's contention that our order will discourage its stockholders from expanding capacity, since the effect of raising new equity capital at prices in excess of book value is to increase the book value of its common stock. The rate of return as determined by our interim order will not adversely affect Tennessee's financial integrity, nor impair its continued growth. It is sufficient to attract new capital to Tennessee and provides a fair return to Tennessee on its net investment rate base.

Tennessee objects to any interim reduction of its rate of return with respect to its production properties. Tennessee, however, has not sought and the record shows no need for, a different rate of return on its production properties than on its pipeline properties. Accordingly, the 6¼ per-

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cent rate of return found to be fair, just and reasonable for the interim order applies to all of Tennessee's properties. It is true that this rate of return is subject to adjustment in the next phase of the proceeding, insofar as the production properties are concerned, by reason of the reservation of the question of how to treat tax benefits

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for statutory depletion and intangible well drilling costs in the light of *El Paso Natural Gas Company*, 22 F.P.C. 260 (1959) and *United Fuel Gas Company*, 23 F.P.C. 127 (1960). However, Tennessee will not be deprived during the interim period of any return to which it may be entitled by reason of such benefits, regardless of how the Commission finally disposes of this question—whether by an increased return on production properties or otherwise. Tennessee has included all such tax benefits to its cost of service and will be able to recover all such costs subject to refund pending the Commission's determination of the proper treatment of such benefits.

The interim order requiring refunds and providing for the filing of lower rates based on the 6⅛ percent rate of return will result in annual savings to Tennessee's jurisdictional customers of $11,001,825 pending final determination of Tennessee's rates in this proceeding, and is both necessary and appropriate to protect the interests of such customers. The order in no way prejudices the rights of any property in this proceeding, and, as we have found is a lawful exercise of our authority in carrying out the purposes of the Natural Gas Act.

The Commission finds:

The assignments of error and grounds for rehearing contained in the applications for rehearing of the Commission's order of August 9, 1960, in this proceeding, set

forth no new facts or principles of law which were not fully considered by the Commission when it issued that order, or which having now been considered warrant any change or modification thereof.

The Commission orders:

The above applications for rehearing of the Commission's order of August 9, 1960, in this proceeding, are hereby denied.

By the Commission. Chairman Kuykendall dissenting.

J. H. Gutride
Joseph H. Gutride,
Secretary

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(Received June 13, 1960)

UNITED STATES OF AMERICA
BEFORE THE FEDERAL POWER COMMISSION

Docket No. G-19983

In the Matter of

Tennessee Gas Transmission Company

Memorandum of Tennessee Gas Transmission Company in Opposition To Staff Motion for Interim Order

On May 25, 1960, after the completion of the evidence on the issue of rate of return, Staff Counsel orally moved that the Commission issue an interim order determining the issue of rate of return. The motion contemplates that if the Commission finds that a rate of return of less than 7% (the return claimed by Tennessee in this case) is fair and reasonable, immediate refunds and rate reductions by Tennessee would be ordered to the extent that the revenues from the filed rates exceed the resulting lower cost of service. For the purpose of the interim order only,

Tennessee's presentation as to rate base, method of allocation, and cost of service (other than rate of return and related income taxes) is to be used. Omission of the intermediate decision procedure was also requested as to the issue of rate of return (Tr. 1616-1617).

For the reasons discussed below, Tennessee opposes the Staff motion

I

At the outset we wish to make it crystal clear that Tennessee wholeheartedly supports the Commission's efforts to expedite the trial and decision of rate cases. We also wish to make it clear that while we doubt that the piecemeal trial and disposition of certain selected issues will,

in itself, result in the over-all expedition of rate cases, we would, nevertheless, in the spirit of cooperation not oppose an interim order on the issue of rate of return, if that issue were independent of other issues. However, we must, and do, vigorously oppose the interim order procedure in this particular case due to the fact that an inseparably related issue—the issue of zone allocation—is, as yet, undecided. We respectfully submit that, because of this fact, an interim order requiring refunds and rate reductions would be unlawful.

II

As the Commission knows, prior to Docket G-5259, every Tennessee rate case was disposed of by agreement among the Commission Staff, Tennessee and Tennessee's customers. Those agreements went to the over-all cost of service as well as to the rate differentials among the zones on the Tennessee system. The issue as to the method to be used for allocating costs among Tennessee's six rate zones was raised in Docket G-5259, but, with the consent of

all concerned, was dismissed in view of the fact that the issue was involved in the then (and still) pending rate case in Docket G-11980.

After Tennessee completed the presentation of its direct case in Docket G-11980, a motion was filed on March 17, 1959, by the Consolidated system companies requesting that the zone allocation issue be severed from the cost of service issue, and that the case proceed to hearing and decision first on the zone allocation issue only. This motion was granted by the Commission's order of April 30, 1959. Lengthy hearings have been held and extensive briefs have been filed. The matter is now pending a

decision by Presiding Examiner Zwerdling.

The method of allocation advocated by Tennessee is a combination of the two principal methods previously followed by the Commission in assigning costs to zones, namely, (1) the Mcf-mile method of allocation, and (2) the application of historical rate differentials. The Staff and New England intervenors advocated the Mcf-mile method (with certain differences not pertinent here). The Consolidated system companies and the Columbia system companies advocated variations of the zone by zone (zone gate) method of allocating costs.

No new cost allocation evidence has been presented in the instant docket. The Examiner has ruled that in view of the pendency of that issue for decision in Docket G-11980, he will not re-try that issue in the instant case (Tr. 302). Tennessee agrees with this ruling.

III

The fact that different methods of allocation have been proposed is not important in and of itself. What is im-

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portant however—and of crucial significance so far as the Staff's motion is concerned—is the fact that the respective zones as well as services (and, indeed, even the demand and commodity components), are allocated a different proportion of Tennessee's over-all cost of service *depending upon which method of allocation is used to allocate that cost of service.* For example, reference to Exhibit 139 (pp. 1-5) in Docket G-11980 shows the following differences in costs[1] allocated to gas sales in the six Tennessee rate zones by the

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different methods of cost allocation (and variations thereof) proposed in that proceeding.[2]

Tabulation A

Sales Zone	(1) Columbia	(2) Consolidated	(3) New England	(4) Staff	(5) Tennessee
Southern	$ 23,014,151	$ 22,131,880	$ 23,182,434	$ 23,142,175	$ 22,683,241
Central	17,067,755	16,891,574	17,533,137	17,361,176	17,461,793
Eastern	62,037,218	62,233,762	67,976,129	67,029,625	66,460,794
Northern	32,534,546	32,963,603	33,572,626	32,530,478	33,503,195
New York	26,613,333	27,937,077	26,394,342	26,367,457	27,014,352
New England	23,852,427	21,607,221	16,823,086	19,354,014	18,614,416
Total[3]	$185,119,430	$184,765,117	$185,481,754	$185,784,925	$185,737,791

It can be readily seen from the above tabulation that differences of as much as approximately $7,000,000 a year in the costs allocated to a particular zone can result on the

[1] We have utilized, without prejudice, the Staff's claimed cost of service in Docket G-11980 for the purpose of this illustration.

[2] While the figures in Tabulation A would in all cases be different in the instant proceeding inasmuch as we are dealing with a different cost of service, the Docket G-11980 figures are, nevertheless, valid for the purpose of illustration.

[3] The relatively minor differences in the various totals are due to the differences in the balance of the cost of service allocated to Transportation and non-jurisdictional services. Those differences are reflected in Exhibit 139 in Docket G-11980, but are not pertinent to this comparison.

Tennessee system from the use of different allocation methods. Thus, Columbia would allocate $23,852,427 a year to the New England zone under its zone gate method of allocation, whereas the New England intervenors would allocate $16,823,086 to that zone under the Mcf-mile method. Columbia would allocate to the Eastern zone $62,037,218 whereas the New England intervenors would allocate $67,976,129 to that zone. Under the method proposed by Tennessee, $18,614,416 would be allocated to the New England zone and $66,460,794 would be allocated to the

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Eastern zone.

It can also readily be seen from the foregoing that unless the rates filed by Tennessee in each zone produce revenues equal to the cost of service allocated to each zone under the allocation method ultimately selected, a retroactive rigid application of the selected method of allocation would prevent Tennessee from recovering its total cost of service. This is so inasmuch as the excess revenues in certain zones later found to be refundable, could ~~not then~~ be offset by a retroactive increase in other zones' revenues.

IV

As previously stated, the Staff's motion contemplates that such refunds and concomitant interim rate reductions as may be required by an interim order will be made on the basis of the Tennessee method of cost allocation and rate design. Such procedure has surface plausibility. Closer analysis, however, indicates conclusively that the procedure cannot legally, and should not as a practical and equitable matter, be adopted in this particular case.

Under the Natural Gas Act, Tennessee files *rates* (not cost allocations) for each zone. Before such filed *rates* for any particular zone can be reduced by way of an interim

order or by way of a final order at the conclusion of the proceeding, there must be a finding that the *rates* for the zone in question are unjustly or unreasonably high. But *how can the Commission make such a finding without first having determined the method of cost allocation to be employed to test the reasonableness of those rates?* Where the method of cost allocation has been determined or is not in issue,

the Commission is not confronted with such a problem. But where, as here, the method to be employed in allocating costs among zones on the Tennessee system is pending decision, we submit that the required finding cannot be made until the allocation issue is determined.

Moreover, one of the very matters at issue in Docket G-11980 is whether the Commission, if it adopts a method of cost allocation different from Tennessee's, should make its method retroactive to July 14, 1957 (the date the G-11980 rates became effective subject to refund), or whether such different method be made prospective only from the effective date of the allocation order. Tennessee has taken the position that any new method of allocation adopted by the Commission should be made prospective only; that it would be wholly inequitable and a denial of due process to apply a new allocation method retroactively, if such application deprived Tennessee of any part of the rate of return to which it is entitled. The Columbia companies and the New England intervenors contend that, as a matter of law, any new method of allocation must be applied retroactively to the beginning of the refund period. The Staff contends that any new method of allocation be applied retroactively, but qualifies its position by observing that the serious impact on Tennessee that might result by reason of a retroactive application of a method different from that used by Tennessee must "be given weighty con-

sideration, which, in part, would at the appropriate time reflect the judgment of the Presiding Examiner or the Commission whether the method approved should be rigidly applied to the past period" (Staff Brief in Docket G-11980, p. 58).

As previously stated, the instant motion of the Staff contemplates

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that the Tennessee allocation method would be used to make interim refunds and rate reductions stemming from the proposed interim rate order on rate of return. However, if, subsequent to making such interim refunds and rate reductions, a method of allocation different from that used in making the interim refunds and rate reductions is applied retroactively to the beginning of the refund period, Tennessee would, as stated above, be unable to recover its total cost of service, inasmuch as Tennessee cannot file a retroactive increase in rates. In other words, the Commission cannot lawfully now determine the rate of return to which Tennessee is entitled, when a later *nunc pro tunc* determination on a related phase of the case (allocation) could prevent Tennessee from earning the full rate of return allowed.

Thus, suppose, for illustrative purposes, that the total cost of service assigned to the sales zones in an interim order is \$185,784,925 (which is the Staff proposed jurisdictional cost of service for the sales zones in Docket G-11980 shown in the above tabulation). If Tennessee's method of cost allocation is used, interim refunds and rate reductions would be predicated on the allocation of costs to the six Tennessee rate zones shown in column (5) of Tabulation A above. Should, however, either the Columbia method or the New England method of cost allocation be subsequently adopted and applied retroactively, the

following excesses or deficiencies in revenues would result in the several rate zones:

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Excess or (deficiency) of Revenue Resulting from Subsequent Cost Allocation Determination

Zone	Columbia Method [4]	New England Method [5]
Southern	$ (330,910)	$ (499,193)
Central	394,038	(71,344)
Eastern	4,423,576	(1,515,335)
Northern	968,649	(69,431)
New York	401,019	620,010
New England	(5,238,011)	1,791,330

It can readily be seen from the first column of figures that Tennessee, under the circumstances assumed, would, when the final allocation order is entered, have to make *additional* annual refunds of $5,687,282 in all zones except the Southern and New England zones. Of vital importance, however, is the fact that in the latter two zones, Tennessee would have previously refunded, pursuant to an *interim order*, a total of $5,568,921 per year too much (or collected insufficient revenues by such amount) which it could not recoup. It would, therefore, have been deprived of the right to earn the allowed rate of return by the same amount.

From the second column of figures, it can be seen that, under the same circumstances assumed, Tennessee would, when the final allocation order is entered, have to make an *additional* refund in the New York and New England zones, but as to the remaining four zones it would, pursuant to an *interim order*, have previously refunded $2,145,303 per year too much (or collected insufficient revenues by such

[4] Differences between columns (1) and (5) of Tabulation A.

[5] Differences between columns (3) and (5) of Tabulation A.

amount), thereby preventing it from earning the allowed rate of return by the same amount.

Patently, the situation depicted above would result in confiscation because Tennessee would be deprived of the earnings available from the rate of return to which it is entitled.

V

It may be contended that the situation described above could only come about if the Commission were to require the selected method of allocation to be applied retroactively; but that the Commission, if it issues an order requiring interim refunds and rate reductions, would not thereafter put the company in a position where it would be denied the right to recover the allowed cost of service. If such contention is made, it would appear to presuppose that the Commission will not make any new method of allocation retroactive. While we are of the view that any new method of allocation adopted for the Tennessee system should, and legally can, be made prospective only, others, as shown above, are of a different view. If they should ultimately prevail before the Commission or the Courts, Tennessee, regardless of the equitable intentions of the Commission, would suffer irreparable financial loss from having made interim refunds and rate reductions prior to a final decision on zone cost allocation.

Apart from the foregoing, it would seem to us that such contention, if made, presupposes a pre-judgment by the Commission of the very issue now pending before Examiner Zwerdling in Docket G-11980. As stated above, the question of prospective or retroactive application (or degree of retroactive application) of the method of allocation to be selected is pending decision in Docket G-11980. It seems to us that basic fairness to Tennessee and all of

its customers requires that such issue not be prejudged—as it were—by the Commission taking action now by way of an interim rate order which will make it more difficult for the Commission later to decide the issue unfettered by the consequences flowing from a hasty previous action.

VI

It is no answer to say—as may be contended by the Staff—that Tennessee has the responsibility of filing rates; that it must assume the risk that those rates will not recover the cost of service in the event such rates were designed on the basis of a method of allocation different from that which the Commission ultimately selects as the fairest method for the Tennessee system; and that, therefore, it is appropriate to place the responsibility on Tennessee for selecting the method to be used for allocating costs to zones for the purpose of making interim refunds and rate reductions. Assuming, *arguendo*, that when Tennessee filed increased rates it assumed the type of risk discussed above, such risk is one voluntarily assumed by Tennessee. A risk voluntarily assumed is one thing. It is quite another thing when the Commission, by order, imposes and increases the risk upon Tennessee of not being able to recover the rate of return allowed by *the Commission*. And, as shown above, such a risk would be imposed upon Tennessee if interim refunds and rate reductions are ordered, without first having determined the method of cost allocation and rate design to be used. The imposition of such a risk, we submit, would be unlawful.

Moreover, from the standpoint of simple fairness—assuming *arguendo* the legal validity of an interim refund and rate reduction order in this case—Tennessee should not be put in the position of not being able to earn the return to which it is found to be legally entitled because

of its inability to predict the allocation method ultimately to be adopted Tennessee has selected a method of allocation which, in its judgment, is fair to all the customers on its system. The method selected,

as stated above, combines the two methods previously used by the Commission in allocating costs on pipeline systems. But, as pointed out in our Initial Brief (pp. 3-6) in Docket G-11980, cost allocation "is not a matter for the slide rule." On the contrary, "it involves judgment on a myriad of facts. It has no claim to an exact science." In other words, "consideration of fairness, not mere mathematics, govern the allocation of costs." *Colorado Interstate Gas Co. v. Federal Power Commission*, 324 U.S. 581, 589, 591 (1945). Should the Commission now embrace a method of cost allocation different from those previously prescribed or approved by it, considerations of fairness, we respectfully submit, dictate that Tennessee should not be penalized by a *nunc pro tunc* order applying such new and different method. And if this be so, certainly simple logic and fairness also dictate that no interim order be adopted which can put Tennessee in such jeopardy. This is particularly so because no customer can be prejudiced by a denial of the instant Staff motion, in view of Tennessee's obligation to refund excess charges with interest.

VII

Tennessee is greatly interested in expediting the disposition of its rate cases. It desires to, and will, cooperate with the Staff and the Commission to that end. It feels most strongly and keenly, however, that because of the pendency of the allocation issue, an interim order is clearly unlawful and, if issued, would unduly complicate this case.

We urge the Commission, therefore, in view of all the circumstances and considerations discussed above, to deny

the Staff's motion. This is especially appropriate in view of the fact that the zone allocation issue

is now pending decision by Examiner Zwerdling, and a decision thereon by the Examiner and the Commission can be expected in the reasonably near future. Indeed, we are inclined to the view that the ultimate disposition of the three pending Tennessee rate cases will be hastened by the early disposition of the cost allocation issue.

VIII

We have been able to find three cases where interim rate orders of the Commission have been sustained by the courts, namely, *F.P.C. v. Natural Gas Pipeline Company of America*, 315 U.S. 575 (1942); *State Corporation Commission of Kansas* v. *F.P.C.*, 206 F. 2d 690 (8th Cir., 1953); and *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 236 F. 2d 606 (3rd Cir., 1956). None of those cases, we submit, constitute legal precedent for the type of interim order proposed by the Staff here.

The *Natural Gas Pipeline* case was a Section 5(a) proceeding, wherein for the purpose of issuing an interim rate reduction order, the Commission accepted the company's claimed cost of service, except for the element of rate of return which was decided upon the basis of a complete record. It must be noted, however, that the Commission's order was *prospective* only. There was *no* possibility that a later order in the *same* case could be made *retroactive*. Thus, there was no possibility that Natural Gas Pipeline could be deprived of any part of its cost of service by a later order in the same case. This case, therefore, clearly is no precedent for the Staff's motion.

The *Kansas Corporation* case (*Northern* case) involved a situation wherein three separate rate increases had been filed by Northern. While

the third increase (Docket No. G-1881) was still in the hearing stage, the Commission decided the first two cases (Opinions 228 and 228-A; 11 F.P.C. 123). Opinions 228 and 228-A effectively disposed of various issues upon which $7,601,853 of Northern's third rate increase was predicated. As noted by the court (206 F. 2d at p. 715), items of increase aggregating $7,601,853 "in the third rate increase proposal were items included in and tried out and decided adversely to Northern by the Commission in Opinion No. 228." In view of that fact, the Commission granted a motion dismissing Northern's third rate increase to the extent that the issues involved had just been decided adversely to Northern's contentions. Northern obtained a stay pending review of all three orders.

Unlike the instant case, there was no outstanding zone allocation issue. On the contrary, at that time Northern had uniform system-wide rates. Thus, there was no possibility that a subsequent order in the same docket (G-1881) could operate retroactively to prevent Northern from recovering its full cost of service. While further rate reductions were possible in Docket G-1881, no such reductions were possible with respect to the issues finally decided in Opinions 228 and 228-A. In other words, no subsequent order could injure Northern in the manner herein discussed.

The *Panhandle* case is practically identical to the *Northern* case. That part of Panhandle's rate increase in Docket G-2506 which was predicated upon issues just decided in Opinion 269 was dismissed, since no change in circumstances had (according to the Commission and Court) been shown. Here also, no allocation of costs to zones remained to be decided. Indeed, one of the issues dismissed was the issue of allocation of cost of service inasmuch as that issue had been decided in Opinion 269.

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shortly prior to the filing in Docket G-2506. As in the *Northern* case, any subsequent opinion in Docket G-2506 could not operate retroactively to deprive Panhandle of the ultimate cost of service allowed by the Commission in that docket.

We come now to an order issued on April 29, 1960 in the current *Panhandle* rate case in Docket G-19780. In that case, as the Commission knows, it set for hearing in the first phase of the case, certain issues, including rate of return. The Commission specifically noted in its order that among the issues to be disposed of in the first phase of the case would be "a cost of service utilizing the allocation principles relied upon by the Commission in Opinion 269, as modified in *City of Detroit* v. *F.P.C.*, 230 F. 2d 810." The matter of cost allocation was not involved, however, in the *City of Detroit* case, unless the Commission, by the quoted language, meant the allocation of costs to the gasoline extraction operations. Be that as it may, the fact is that, in the current *Panhandle* rate case, confusion has arisen as to whether or not cost allocation and rate design principles are at issue in the first phase of the case. Counsel for Panhandle interprets the order as meaning that cost allocation and rate design are at issue. Staff Counsel contends that those matters are not in issue. The Presiding Examiner in that case has permitted evidence pertaining to cost allocation and rate design to be introduced in the first phase of the proceeding. On June 8, 1960, Staff Counsel stated that he would take an appeal to the Commission from the ruling of the Examiner permitting such evidence to be introduced.

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It is not our purpose to argue the pros and cons of the recent Panhandle order. We think it is important to point

out, however, that in Opinion 269 the Commission adopted a method of cost allocation for the Panhandle system. No method of cost allocation has ever been adopted by the Commission for use on the Tennessee system. That there is a need for an early decision as to the method of cost allocation to be used on the Tennessee system is attested to by the Commission's aforementioned order of April 30, 1959 (in Docket G-11980) requiring the hearing and decision on the cost allocation issue to precede the hearing and decision on the cost of service issues in that docket. That hearing has been completed. Briefs have been filed. A decision will soon be forthcoming. These facts are not present in the Panhandle case. These facts, we submit, clearly require a denial of the Staff's motion herein, wholly aside from the propriety or impropriety of the Commission's action in the Panhandle case, as to which Tennessee takes no position here.

IX

In addition to the arguments and reasons set forth above in opposition to the interim order procedure, there is a special circumstance which provides a peculiarly cogent reason for not issuing an interim order in this case. It is the imminence of a decision on the cost allocation issue now pending in Docket G-11980.

The zone cost allocation issue in that docket has been tried in great detail and at great expense over a long period of time. A decision by the Presiding Examiner should be forthcoming in the near future. As noted previously, the Examiner in the instant case (who is also the Examiner

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in Docket G-11980) has properly ruled that the allocation issue is not to be retried in this case. In other words, the allocation method selected in Docket G-11980 will be applicable to the instant case.

In the light of the foregoing, apart from the legal questions involved, it would be imprudent and impractical, as well as expensive, if Tennessee were required to make new rate filings as a result of an interim order, and shortly thereafter be faced with the necessity of substituting a different set of rates as a result of the decision on the allocation issue. We respectfully submit that sound administration and logic requires waiting the relatively short time involved until the decision on the allocation issue is made.

In the light of all of the foregoing, we urge the Commission to deny the Staff motion.

REQUEST FOR ORAL ARGUMENT

In view of the importance of this matter, we respectfully request the opportunity to argue the matter orally before the Commission.

Respectfully submitted,

TENNESSEE GAS TRANSMISSION COMPANY
By /s/ HARRY S. LITTMAN
Harry S. Littman
Its Attorney

W. C. BRADEN, JR.
B. J. WILLIAMSON
Tennessee Building
Houston 1, Texas

HARRY S. LITTMAN
JACK WERNER
HAROLD L. TALISMAN
317 Wyatt Building
Washington 5, D. C.
Attorneys for Tennessee Gas Transmission Company

June 13, 1960.

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(Received June 13, 1960)

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Docket No. G-19983

In the Matter of

TENNESSEE GAS TRANSMISSION COMPANY

Memorandum, Answer and Objections of the Manufacturers Light and Heat Company, the Ohio Fuel Gas Company and United Fuel Gas Company to the Motion of Staff Counsel For Interim Refund Order.

The Manufacturers Light and Heat Company, The Ohio Fuel Gas Company and United Fuel Gas Company (Columbia Companies), Intervenors herein, pursuant to the direction of the Presiding Examiner (T. 1629), respectfully state that:

(1) A prompt decision on the rate of return issue in this proceeding, together with a prompt decision by the Presiding Examiner of the allocation issue now pending in Docket No. G-11980, would open the door to settlements of Tennessee's three pending rate cases.

(2) Columbia Companies would agree to a waiver of the intermediate decision procedure for the limited purpose of determining a proper rate of return for Tennessee in this proceeding.

(3) Columbia Companies must oppose the Staff proposal for an interim refund order because such an order (a) would aggravate and complicate a long-standing and serious situation of undue discrimination in Tennessee's rates, and (b) would be illegal in view of the status of the allocation issue.

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In respect whereof Columbia Companies state:

I. The Controversy in Context

The broad problem involved pertains to a determination

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of just and reasonable rates for Tennessee Gas Transmission Company (Tennessee) from and after April 5, 1960, at which time the filed rates became effective subject to refund. The Staff motion seeks interim, or tentative changes in Tennessee's effective rates. These tentative rates would then be subject to a subsequent determination that the same are too high or too low with respect to any particular rate schedule and zone. In short, the Staff would have quick action ordering piecemeal refunds to particular customers* before the completion of final determinations in *prior* dockets and before *full* hearings in *this* docket. Contrasted with this is the approach of Columbia Companies who seek a speedy *final* determination of the just and reasonableness of Tennessee's rates within the confines of the legal procedures set by the Natural Gas Act and Administrative Procedure Act.**

A. *The Status of Pertinent Proceedings*

This proceeding, Docket No. G-19983, is the third of three pending rate cases of Tennessee. The underlying rates of Tennessee were determined after a settlement in Docket

* At T. 1624, Staff Counsel opines that the "small customers" of Tennessee are interested in quick refunds "in order to be able to sell the gas that they are purchasing from Tennessee" and leaves the inference that such are entitled to preference over the interests of the "larger intervenors" which may result from the cost allocation determination. There is no warrant in the record for these gratuitous and debatable assumptions or opinions.

** "Motion To Expedite Proceedings" dated May 11, 1960, filed by Columbia Companies in Docket Nos. G-11980, G-17166 and G-19983.

No. G-5259, by order issued October 17, 1957. The two pending

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rate cases, Docket Nos. G-11980 and G-17166, which were initiated prior to the instant case, have the following procedural status:

Docket No. G-11980. Tennessee's rates filed in this docket became effective subject to refund on July 14, 1957. These rates were in effect for twenty-two months until they were superseded by the rates in Docket No. G-17166 on May 15, 1959. Hearings commenced in Docket No. G-11980 on April 16 1957, and continued intermittently until December 17, 1959. *On the separated issue of cost allocation,* the hearing has been closed. Initial and Reply Briefs were filed on March 14 and April 11, 1960. The issues relating to the allocation of costs among Tennessee's various rate zones and classes of customers is now pending before the Presiding Examiner for an interim decision, which, when acted upon by the Commission, will have a controlling effect in subsequent Tennessee dockets. (Cf. G-19983, T. 299-302)

Docket No. G-17166. The Tennessee rates involved in this docket became effective on May 15, 1959, and were in effect for almost eleven months until superseded on April 5, 1960, by the rates filed in Docket No. G-19983. No hearings have been held with respect to G-17166, with the exception that the cost allocation determination in Docket No. G-11980 was specifically contemplated by the Commission to be

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applicable to this proceeding.*

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* By its order severing issues in Docket No. G-11980 issued April 30, 1959, the Commission stated:

"Hearings in this proceeding were commenced on April 16, 1959, and have proceeded through cross-examination on Tennessee's case in chief

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Docket No. G-19983. The instant proceeding, Docket No. G-19983, as aforesaid, pertains to Tennessee's rates which became effective subject to refund on April 5, 1960. Hearings commenced on February 2, 1960, and have been held intermittently for 13 days through May 25, 1960. Tennessee presented its direct case upon all of the issues involved, including the individual items of cost of service, cost allocation and proposed rates. Of these issues the "rate of return" element of Tennessee's total cost of service is the only one in relation to which the evidentiary record is closed. Tennessee's rate of return presentation was contested by several of the parties and rebuttal evidence on that single issue was presented. As to all issues, other than rate of return, none of the Tennessee witnesses have been cross-examined and none of the parties to the proceeding have been permitted to offer rebuttal evidence.

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The Examiner would *not* permit evidence showing the allocation of return among zones and services in any manner other than that proposed by Tennessee.* Tennessee used the same method which was so hotly contested in

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and preparation and service of proposed testimony and exhibits by the Staff and intervenors. Reconvening of hearings herein is presently scheduled for May 12, 1959. In the interim Tennessee has proposed a further rate increase at Docket No. G-17166. The level of rates determined in this proceeding may thus be effective only for a 'locked-in-period.' *It is our view that separate and prior hearing on the issues relating to the principles and methods to be applied toward allocation of costs among the zones on Tennessee's system and among the classes of service within the zones will aid in the disposition of this proceeding and may be of similar aid in disposition of proceedings in Docket No. G-17166.''*

We endorse wholeheartedly the underlined statement of the Commission.

* In point of fact the Presiding Examiner has specifically ruled that he will not receive rebuttal evidence on the issue of cost allocation with or without a reduction in allowable return. (T. 302, 1235-1241)

Docket No. G-11980, which is now pending before the same Examiner.

The record would therefore only permit a determination of a part of the rate of return issue. If a determination should be made as to the amount of return to which Tennessee is entitled without a determination as to what portion of such return should be paid by Tennessee's various zones and classes of customers, Tennessee would not be able to make a refund of the excess. It would not know to whom and in what amounts any such refund should be made. Tennessee could not make refunds on the basis of its own proposed allocation method, knowing full well that such allocation method may not be approved by the Commission or the Courts.

The Commission cannot lawfully require refunds to be made in any particular manner without first permitting Tennessee and its customers to be heard with respect to the allocation of such refunds. Such action would either (a) predetermine issues not previously decided in any case, and not yet heard in this proceeding and with respect to which the parties have been denied the opportunity to offer evidence, or (b) subject Tennessee to a retroactive decision as to how it should have made the refunds. Such action would either deprive Tennessee's customers of due process of law by prejudging the

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the allocation issue or subject Tennessee to confiscation of its property if its proposed allocation method is rejected.

B. *Staff Motion; Examiner's Direction*

In this context Staff Counsel moved orally on the record: "that the record on rate of return be considered and an order issued thereon determining the fair rate of return for Tennessee"

and

> "depending upon the . . . fair rate of return that is determined, if it is anywhere lower than 7 percent, that immediate refunds be ordered by Tennessee for the difference between the claimed or the proposd 7 prcent of return and that determined . . ., and that for the purpose of that immediate refund all other presentation insofar as rate base and method of allocation between the zones be used as presented by Tennessee" (T. 1616).

In addition to either supporting or opposing the Staff motion, the Examiner directed the parties to give their views

> "not only to the question of whether there should be an interim order or decision, but also as to what type of refund order should be issued as a result of the interim decision" (T. 1635).

II. Columbia Companies Are Opposed To Any Interim Refund Order In This Proceeding

A. *An Interim Refund Order Would Aggravate and Complicate Tennessee's Unduly Discriminatory Rate Situation.*

For many years and in many proceedings Columbia Companies have been complaining to the Commission and the Courts that Tennessee has been *overcharging* them and those similarly situated in Tennessee's Zones 2, 3 and 4, and at the same time *undercharging* customers in Tennessee's Zones 1, 5 and 6. Columbia Companies' complaints remain unresolved to date. Columbia Companies contend that Tennessee has violated

Section 4(b) of the Natural Gas Act with respect to undue rate discrimination. Columbia Companies have contended that this rate discrimination is due in large part to Tennessee's method of cost allocation underlying its rates to certain classes of customers in its six rate zones.

This cost allocation controversy alone involves millions of dollars. For example, a determination of this single issue in Docket No. G-11980 could adjust Tennessee's costs and rates based thereon among its six zones, as follows:

Results of Cost of Service Studies By Zones

*Tennessee Method Compared with Columbia Method**

Zones (1)	Tennessee Study (2)	Columbia Companies Study (3)	Tennessee Study Compared To Column 3 Deficiency (4)	Excess (5)
1 (Southern)	$ 22,683,241	$ 23,014,151	$ 330,910	—
2 (Central)	17,461,793	17,067,755	—	$ 394,038
3 (Eastern)	68,785,167	64,061,375	—	4,723,792
4 (Northern	41,086,996	39,478,529	—	1,608,467
5 (New York)	31,349,226	32,414,825	5,238,011	—
6 (New England)	18,614,416	23,852,427	5,238,011	—
Total	$199,980,839	$199,889,062	$6,634,520	$6,726,297

It is clear that if Columbia prevails on the allocation issue in Docket No. G-11980, Tennessee will have allocated more than 6½ million dollars too much to the middle rate zones and that its allocations to other zones will have to be increased by more than 6½ million dollars. This comparison points up the fact that it is impossible for Tennessee to refund any excess revenues until the Commission decides

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* These cost allocation comparisons are derived from Docket No. G-11980, Exhibit 128, line 1 (one of four studies made by Columbia Companies) and line 10 (Tennessee study); see Tab M, Appendix to Columbia Companies' Brief dated March 16, 1960.

which of Tennessee's customers have been overcharged and in what amounts.

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It is impossible to determine a comparable range of similar cost allocation adjustments in Docket No. G-19983 because the Examiner's rulings aforesaid have precluded the other parties from determining or introducing evidence upon the cost allocation issue other than that used by Tennessee in its filing. However, it is clear that any such similar adjustment would be substantial.

Faced with such an important contested issue now ripe for determination in Docket No. G-11980, Columbia Companies must oppose any immediate piecemeal refund which is based upon Tennessee's method of cost allocation as a prejudicial aggravation of Tennessee's unduly discriminatory rates.

Historical increases in Tennessee's rates have been *disproportionately* higher in Tennessee's Central and Eastern Zones than in other zones, wherein Columbia Companies purchase substantial volumes of gas in each of the many settlements of Tennessee's cases *since 1947*.* It is submitted that the application of Tennessee's method of cost allocation in an interim refund order would merely cause a progressive deterioration of the unjustifiable rate preferences shown of record in Docket No. G-11980.

B. *An Interim Refund Order Herein Would Be Contrary to Statute and an Abuse of the Administrative Process.*

As stated above Columbia Companies and others have been precluded by the Examiner from submitting evidence

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* See Columbia Companies' Answer to a recent Motion of Consolidated Natural Gas System in Docket No. G-11980, pages 6-7.

on the issue of the allocation of costs in this proceeding. On the other

hand Tennessee and the Commission Staff have been permitted to adduce cost allocation evidence confined to the Tennessee method. It should be emphasized that the Tennessee method of cost allocation has been the subject of complaint by Columbia Companies and others at least from the trial of issues in Tennessee's Docket No. G-5259. *Therefore, there has never been any determination by the Commission on an evidentiary record of the proper method of cost allocation on the Tennessee system.*

Columbia Companies have been denied in advance their right to contest the cost allocation basis upon which the Staff would have the Commission issue an interim refund order. The law is plain that Columbia Companies have a right to adduce evidence on any important and unresolved material issue of facts involved. For example:

1. *Controlling Statute and Rule.*

Natural Gas Act, Section 4(e)—This Act provides "That . . . *after full hearings*, either completed before or after the rate, charge, classification or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective . . . where increased rates or charges are thus made effective, the Commission may . . . require . . . or bond . . . *to refund any amounts ordered* by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase . . . and *upon completion of the hearing and decision*, to order such natural-gas company to refund, with interest, *the portion of such in-*

creased rates or charge by its decision found not justified."*

The statute requires a "full hearing" prior to a refunding order. Columbia Companies have not had a full hearing.

The hearing is not complete even upon the first of the piecemeal portions. The proceeding is not ripe for Commission order "upon completion of the hearing." Here the Commission could only order interim refunds on the basis of *expediency* and could not comply with the statutory requirements that the refunds of the portion of Tennessee's increased rates or charges were "found not justified." Justice demands fair treatment to all. Until the cost allocation issue is determined, fair treatment to all is impossible by an interim refund order.

Administrative Procedure Act, Section 7(c)—This section of the Administrative Procedure Act precluded an order by a Commission

> "except upon consideration of the whole record or such portions thereof as may be cited by any party and as supported by and in accordance with the reliable, probative, and substantial evidence. *Every party shall have the right to present his case* or defense by oral or documentary evidence, *to submit rebuttal evidence, and to conduct such cross-examination* as may be required for a *full* and true disclosure of the facts."

Because of the Examiner's ruling preventing Columbia Companies from adducing evidence on cost allocation, it would be impossible for the Commission to comply with

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* Emphasis supplied in quotations throughout this Memorandum.

this provision of the Administrative Procedure Act, since any order now must necessarily be based upon a truncated and incomplete evidentiary record.

Commission Rule 1.20 (g) (1). Order 217, issued November 20, 1959, in Docket No. R-177 reiterated the procedural truism that

> "*parties* and Staff Counsel shall have the right of presentation of evidence, cross-examination, objection, motion, argument and appeal."

Thus, it is clear that if Staff Counsel has been permitted to adduce evidence of cost allocation and the other parties have not been given equal opportunity, the ordinary principles of fair play have been patently violated.

In the background proceeding involving Tennessee's underlying rates, Docket No. G-5259, the Commission itself recognized the legal principles involved herein. In its Order Granting Motion In Part, issued September 20, 1956, at pages 5 and 6, the Commission stated:

> "Since Tennessee is engaged in rendering jurisdictional and non-jurisdictional service, it is not possible to translate the 'total' of Tennessee's cost of service into jurisdictional 'rate level' without first determining the portion of the 'total' properly allocable to jurisdictional sales. Accordingly, even though we find that it is now appropriate to determine the 'total' of Tennessee's cost of service, *such cost of service cannot be translated into jurisdictional rates (or 'rate level') until decision is made as to the proper method of allocating the 'total' between jurisdictional and non-jurisdictional sales.*"

* * * * * * * * *

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"Moreover, our experience tells us that if in the future a change in Tennessee's zone boundaries or rate differentials is in order, the effect of the resultant rate on particular customers will differ dependent upon what cost of service is found proper here. *On this record, however, it is not possible to now determine what the effect upon particular customers will be until resolution of the cost of service and zone issues.*

"Thus, we are of the opinion that it would not be only premature for us to grant that part of Tennessee's motion requesting that we at this time fix rates to be effective on and after December 15, 1954, it would also be unfair and improper."

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2. *The Cases Apparently to be Relied Upon by the Staff Are Not Precedents for the Order Sought.*

At T. 1625-1627 the Examiner referred to a recent Commission order issued April 29, 1960, *In the Matter of Panhandle Eastern Pipe Line Company*, Docket No. G-19780. Although the order specifically avoided a determination of the issue relating to temporary reductions in Panhandle's rates, apparently the Examiner interpreted the Commission's rejection of objections raised to the Staff motion therein as an indication of its tacit approval of such temporary rate reductions. In said *Panhandle* order the Commission stated:

"An interim order procedure as proposed by staff's motion is not unique to this Commission or other regulatory agencies. The Commission applied an interim order in *Illinois Commerce Commission v. Natural Gas Pipeline Co. of America, et al.*, 2 F.P.C. 218 (1940), 120 F.2d 625 (CA7, 1941), affirmed 315 U.S. 575. Courts have upheld other interim orders issued by this Commission. In particular see *Panhandle Eastern*

Pipe Line Co. v. *F.P.C.*, 236 F.2d 606 (CA3, 1956). See also *State Corp. Commission of Kansas* v. *F.P.C.*, 206 F.2d 690 (CA8, 1953), certiorari denied 346 U.S. 922, rehrg. denied 347 U.S. 1022. For use of the interim order procedure by a state regulatory agency see *Houston Chamber of Commerce* v. *Railroad Commission*, PUR 1930B, 388 19 S.W. 2d 583 (Court of Civil Appeals, Texas, 1929). The Interstate Commerce Commission in its *ex parte* rate increase proceedings utilizes procedures closely analogous to those proposed in staff's motion, e.g., *Ex Parte* No. 175, 281 I.C.C. 557; *Ex Parte* No. 168, 272 I.C.C. 695; *Ex Parte* No. 206, 299 I.C.C. 429."

It is submitted that *these citations are not controlling in the circumstances of the instant case.*

A reading of the first three cases which are the only ones cited that arose under the Natural Gas Act clearly indicates important distinctions which make them inapposite herein:

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(1) The interim orders in those cases were "final" in the sense that they were not susceptible to retroactive adjustment by a subsequent order;

(2) No allocation issues were involved;

(3) The parties having rights determined by the interim orders had just had their "day in court" and a final determination of those issues.

In addition there are particular distinguishing elements of these cases which render them inapposite for the instant controversy.

Illinois Commerce Commission v. *Natural Gas Pipeline Co. of America, et al; sub nom. F.P.C.* v. *Natural Gas Pipe-*

line Co. (1942) 315 U.S. 575. This case arose under Section 5 of the Natural Gas Act so that the interim rate order was *prospective* in effect and no refund was involved.

Moreover, at pages 584-585, the Court said:

> "The first prerequisite to an order by the Commission is that it shall be preceded by a hearing and findings. In this case, while the proceedings were not ended by the interim order, the companies had full opportunity to offer all their evidence both direct and in rebuttal, and full opportunity to cross-examine every witness offered. . . . All the evidence tendered was received and considered by the Commission, and before the interim order was entered counsel for the companies stated to the Commission that they had concluded the direct testimony in support of their case."

Thus, where litigants are contesting one of the basic steps prerequisite to setting rates in various zones, and a "full hearing" has been denied, this case is not authority for an interim refund order.

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Panhandle Eastern Pipe Line Corporation v. *F.P.C.* (1956 CA 3) 236 F.2d 606.

This rate case was heard on a presentation of Panhandle's direct evidence immediately *subsequent* to a *final* determination on contested issues. The Commission was permitted to stand on its prior order because it "found that no new or supervening occurrences had been shown by Panhandle to warrant reconsideration of the commission's recent conclusions with reference to these matters." (p. 608)

In the instant case, however, there is no prior Commission order determining the contested cost allocation issue

after a full hearing. If anything, it is submitted that the record in Docket No. G-11980, militates against the Staff's interim commitment to Tennessee's method of cost allocation as a basis for rate refunds.

State Corp. Commission of Kansas v. *F.P.C.* (1953 CA 8) 206 F.2d 690. (*Northern* case).

This was a rate case similar to the *Panhandle* case, *supra*, wherein an interim order was permitted because certain contested issues were disposed of in an immediately preceding case.

It is important to note that at page 713 the Court said:

> "Whether or not appropriate opportunity to explore the problem of zone rates for Northern is presented in Docket No. G-1881, it is clear that the proponents of zone rates have made no record in this case to afford a basis for the establishment of such rates."

Contrast this failure of the zone rate proponents in the *Northern* case, with the Examiner's preclusion of the preparation and presentation of evidence of cost allocation by the parties in the instant case.

Houston Chamber of Commerce v. *Railroad Commission*, PUR 1930B, 388, 19 SW 2d 583.

This case is inapposite to the problem presented by the Staff motion. The *Houston* case arose under a state statute which provided for *Commission*-initiated rates which "are conclusively presumed to be just, reasonable, and non-discriminatory *until attacked in a direct proceeding authorized by statute for that purpose.*" (page 394) Moreover, these State Commission orders are specifically prospective in operation.

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Contrasted with this is the *Tennessee*-initiated rates which have no statutory presumption of reasonableness, and which are under attack.

Finally, the three I.C.C. cases cited are essentially not in point. Although captioned as *ex parte*, there were actually full hearings and interested parties participated fully in the development of the record. Furthermore, orders in such cases operated prospectively only. There was no requirement that refunds be made subject to a probable future retroactive determination that such refunds should have been made in a different manner. Untried issues were not prejudged. There was no confiscation or denial of due process.

3. *An Interim Refund Order Would Be an Abuse of the Administrative Process Herein.*

As long ago as its order issued October 6, 1955, in Docket No. G-5259, the Commission recognized that "the question of possible unlawful rates between zones is a relevant issue" and that "the charges of unjustness in the rates as between zones require a thorough and exhaustive study to

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determine . . . what method of allocating costs between zones would be fair and equitable to all concerned, in order that just and reasonable rates may be prescribed for each zone."

A subsequent order issued September 5, 1957, in the same docket stated that "the zoning issue can now be most clearly analyzed and presented in Docket No. G-11980."

Subsequent orders in Docket No. G-11980 quoted above make it clear that the Commission desires the cost allocation controversy to be decided in principle and method *in*

Docket No. G-11980 and that decision binding in future cases unless changed circumstances are shown.

It is the position of Columbia Companies in Docket No. G-11980 that an Examiner's decision is required as a matter of law on the issue of cost allocation.* Obviously, then, if the Examiner's decision on this issue cannot be *waived* in Docket No. G-11980, the same issue cannot be ignored completely in Docket No. G-11983.

It is submitted that the Commission is bound by its decision to decide the allocation controversy in G-11980 and any procedural shift (such as an interim refund order) which would undercut or prejudice Columbia Companies which have abided by the Commission's prior rulings is an abuse of the administrative process. (Cf. *Trunkline Gas Co.* v. *F.P.C.* (1957 CA3) 247 F2d 159)

III. If An Interim Refund Order Is Issued, the Commission Should Protect Columbia Companies From the Adverse Effects of Undercollections By Tennessee From Other Customers.

One fundamental evil of the interim *refund* procedure* is that a subsequent determination of the cost allocation issue, contrary to the Tennessee method, may entail substantial undercollections by Tennessee from certain customers. Thus, if Tennessee is permitted a specific overall rate of return in the initial piecemeal determination, Tennessee would either have to absorb its undercollections in

* See Columbia Companies' Answer dated May 27, 1960, to Motion of Consolidated Natural Gas System, pages 9-11.

* Columbia Companies are not opposed to interim *orders per se*. In fact the recent history of Tennessee rate proceedings shows several attempts to separate certain issues for trial and determination. However, these did not entail refunds.

certain zones, and at the same time, necessarily recover *less* than the allowable return, *or else*, other customers would subsidize Tennessee's undercollections.

Since, generally, Tennessee uses the same zonal cost allocation formula in G-19983 as it did in G-11980, it is clear that the issue of substantial undercharges in certain zones still exists. Therefore, Columbia Intervenors oppose any piecemeal rate reductions which would aggravate such undercharges to those zones and would require the Commission to determine Tennessee's rates and refunds to Columbia Intervenors in a prejudicial context.

Columbia Intervenors want it to be made clear that *if the Commission indulges in piecemeal reduction of Tennessee's rates, after determining that there is an improper dollar amount in some item of Tennessee's cost of service, such a piecemeal rate reduction in zones of services on some basis*

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other than that resulting from the final determination of the zoning question in G-11980 could not properly bar the Commission from granting full refunds to Columbia Intervenors after the cost allocation issue is finally decided in Docket No. G-11980 and carried forward into this docket.

If the Commission would permit Tennessee to recoup its full cost of service even though there were undercollections from certain zones or classes of service, it is plain that the other zones and classes of customers, such as Columbia Intervenors, would be subsidizing or "picking up the tab" for those customers who were undercharged. The allocation issue would be prejudged without any evidence and they would be denied due process of law.

Finally Columbia Intervenors observe that several interim final orders in various issues in this case, without

finally disposing of the whole proceeding, are susceptible to a duplication of trial issues and, potentially, a multiplicity of judicial reviews. Thus, instead of simplifying and expediting this proceeding, the exact opposite would occur.

WHEREFORE, Columbia Companies respectfully request that the Commission issue its order on the Motion of Staff Counsel which would:

(1) determine the fair overall rate of return for Tennessee in Docket No. G-11983, and any *subsequent* rate filing where no substantial change in circumstance is shown;

(2) omit the intermediate decision procedure on this isolated issue;

(3) deny the request for an interim refund order.

Respectfully submitted,

BROOKS E. SMITH
Brooks E. Smith
Attorney for
The Manufacturers Light and
Heat Company
The Ohio Fuel Gas Company
United Fuel Gas Company

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Of Counsel:

Brooks E. Smith
James G. O'Neill
120 East 41st Street
New York 17, New York
Attorneys for
The Manufacturers Light and Heat Company
The Ohio Fuel Gas Company
United Fuel Gas Company

William Anderson
John P. Egan, Jr.
800 Union Trust Building
Pittsburgh 19, Pennsylvania
Attorneys for
The Manufacturers Light and Heat Company

W. F. Laird
Ralph N. Mahaffey
99 North Front Street
Columbus 15, Ohio
Attorneys for
The Ohio Fuel Gas Company

R. K. Talbott
Herbert W. Bryan
Post Office Box 1273
Charleston 25, West Virginia
Attorneys for
United Fuel Gas Company

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